The Value Creation Mythology

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Richard Collier

Oxford University Centre for Business Taxation

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THE VALUE CREATION MYTHOLOGY[1]

Richard Collier, Associate Fellow at the Oxford University Centre for Business Taxation[2]

One does not have to travel very far into the bourgeoning literature on the subject of value creation before encountering lofty claims as to its status in the international tax firmament. For example:

> "Today, the core principle of the international tax system is taxation of profits in the place where value is created. The discipline of transfer pricing was developed to assess the key value factors in the value creation chain of a transnational corporation and to attribute this figure to location."[3]

And again:

> "the international community is converging towards better alignment of tax systems to ensure that profits are taxed where economic activities generating the profits are performed and where value is created."[4]

And again:

> "value creation provides a valid expression of the underlying purpose of the international transfer pricing regime"[5]

The theme has also advanced to the non-specialist press:

> "It has become generally accepted that the international tax system is based on the principle that the profits of a business should be taxed in the countries in which it created value."[6]

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[1] The use of the term mythology echoes the use of that term by the French philosopher and essayist Roland Barthes. Barthes regarded mythologies as socially constructed naturalisations of concepts or beliefs which deviate from reality. See Roland Barthes, Mythologies, Vintage Classics, 2009.

[2] My thanks are due to Joe Andrus and John Vella for their comments on an earlier version of this paper and similarly I am also grateful for the comments, given in a personal capacity, of Ian Dykes and Alistair Pepper on that earlier version of this paper.

[3] Olga Solovyova, Introduction, Transfer Pricing and Value Creation ed.s Petruzzi/ Tavaresto, Linde Verlag, 2019.

[4] European Parliament Briefing, Multinational enterprises, value creation and taxation, July 2019, p.6.

[5] S Langbein and M Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409 at p.287.

[6] Franklin Cachia, Substance and Value Creation, Times of Malta Sunday Newspaper, 15 December 2019, available at: https://www.csbgroup.com/malta-news/tax/substance-and-value-creation/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration

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There is an industry of value creation discussion, with the subject explored in numerous books, research monographs, PhD theses, blogs, etc. that are devoted to the topic.[7] There is no sign of a let up in the interest which the subject garners.[8]

This paper is concerned with exploring whether the apparent elevation of value creation into a core principle or paradigm of the international tax system is warranted. To that end, this paper addresses three questions: (1) What does the term value creation actually mean or refer to? (2) Does the notion of value creation have a firm basis as a principle in the international tax system? and (3) Is it helpful to posit value creation as a paradigm or principle for interpreting or applying the arm's length principle (ALP)?

Before addressing these three questions, it may be helpful to comment briefly on the context in which the notion of value creation is being considered in this paper. It is potentially important to do so because some of the more expansive claims about value creation seem to regard the notion as foundational to the international tax system *in its entirety* rather than (as in the more limited way that is assumed in this paper) as a concept that is primarily relevant to the topic of income allocation - and specifically Articles 7 and 9 of the OECD Model Tax Treaty.[9] Claims that value creation is foundational to the entire international tax system would seem to the author to be highly problematic in a number of respects, as well as being evidently at variance with the use and intended meaning of the term when it was introduced in the BEPS project. In any event, claims that value creation is or should be a guiding principle for the purposes of the income allocation rules seem stronger than those supporting a wider relevance of the notion in the international tax system.[10] The discussion here therefore considers the merits of the claims made by the proponents of value creation where those claims are the strongest, namely the use of the value creation notion in the context of the income allocation rules.

The conclusion reached is that value creation is for a number of reasons neither apt to describe the existing transfer pricing system nor appropriate or useful as a normative concept that represents some paradigm or principle to be aspired to. It follows that, if the descriptive and normative claims of value creation fail where they are strongest, then a fortiori the case in support of a more expansive relevance of value creation falls away.

1. What does the term value creation actually mean or refer to?

[7] For example: R. Petruzzi et al., Transfer Pricing and Value Creation, Series on International Tax Law, Linde Verlag, 2019; S. Langbein and M. Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409; M. Herzfeld, Value Creation, Digital Users, and the History of Things, Tax Notes Intl. (20 August 2018); M.P. Devereux & J. Vella, Value Creation as the Fundamental Principle of the International Corporate Tax System, Eur. Tax Policy Forum Policy Paper, p. 3 (31 July 2018); S.C. Morse, Value Creation: A Standard in Search of a Process, 72 Bull. Intl. Taxn. 4/5, sec. 2. (2018), Journal Articles & Papers IBFD; J. Hey, "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Intl. Taxn. 4/5, sec. 2.4. (2018), Journal Articles & Papers IBFD; and J. Schwarz, Value Creation: Old wine in new bottles or new wine in old bottles, Kluwer International Tax Blog (21 May 2018).

[8] There are sharply divided views on the merits of the value creation approach. The comments cited above offer a more positive view. For a more sceptical view, see, for example, Allison Christians, Taxing According to Value Creation, 90 Tax Notes International, 1379-1383 (June 18, 2018); Rasmi Das, The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights? Bulletin for International Taxation 2020 vol 74 (3) pp.1-29; and Michael Lennard, Act of Creation: the OECD/ G20 test of "Value Creation" as a basis for taxing rights and its relevance to developing countries, Transnational Corporations, Vol 25, 2018, No. 3.

[9] The European Commission seems intent on assigning to the notion of value creation such a more expansive meaning. See for example the European Commission's justification, based on value creation, of a turnover tax. This is referred to below and at footnote 85.

[10] The basis for this comment includes the textual analysis that follows below in the response to the first question addressed in this paper.

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Much of the commentary on value creation is rather vague when it comes to exactly what the term is being used for or means. However, it is obviously hard to assess the notion by reference to its place in the international tax system or its effectiveness or utility, if it is not defined or at least clarified. This is the first task of this paper.

The emphasised or stylized use of the term stems from the BEPS project.[11] The purpose behind the use of the term when it was first introduced in the BEPS project seems relatively clear when analysed in the context of the early BEPS texts, as the following discussion will aim to demonstrate.

One of the most important themes that is discussed in the first report in the BEPS project, Addressing Base Erosion and Profit Shifting,[12] is the ability of MNEs to use existing transfer pricing rules to shift risk and mobile assets such as intangibles to low tax jurisdictions. This has been a long-standing and fundamental problem for the transfer pricing rules and so it is not surprising that it is referred to throughout the report. The issue is identified as one of the key pressures on tax revenues.[13] It is also highlighted that a number of studies and data indicate there is an increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes.[14] The topic is again revisited in the context of the later discussion in the paper of the use of the transfer pricing rules to create opportunities for BEPS practices, with specific consideration of: the "contractual allocation" of risks and intangibles; whether transfer pricing rules should easily accept "contractual allocations" of risk; and "the level of economic substance required to respect contractual allocations of risk". The summary of the discussion is that "the Guidelines are perceived by some as putting too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group, which may contribute to BEPS."[15] Not surprisingly, it is announced that the forthcoming action plan will include proposals on transfer pricing to deal with such issues "that produce undesirable results from a policy perspective".[16] The discussion does not feature any reference to the notion of "value creation". However, that position changes emphatically by the time of the release of the Action Plan on Base Erosion and Profit Shifting[17] some five months later.

The Action Plan on Base Erosion and Profit Shifting is intended to outline a series of specific actions by way of response to the identified BEPS problems. In setting out the relevant background as a preliminary to the various action points needed to address BEPS practices, an important theme is the weaknesses of existing tax rules. This includes the matter already referred to of "arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place". Reference is also made here to "practices that artificially segregate taxable income from the activities that generate it".[18] Turning to the proposed actions themselves, it is noted in the introductory comments to the actions that a "realignment of taxation

[11] As will be discussed, however, there was some discussion of value creation – or the creation of value – in the months leading up to the BEPS project, including in the first discussion draft arising from the ongoing OECD project on intangibles, which appeared in June 20012. As is also discussed below, though the stylized use of the term "value creation" is first seen in the BEPS project, the underlying issue the term is intended to illustrate is as old as the ALP itself.

[12] OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing. The report was published in February 2013.

[13] In the listing of key pressure areas there is a reference to the shifting of risks and the artificial splitting of the ownership assets – see OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, p.6.

[14] The discussion appears (with the relevant text emboldened for emphasis) in Chapter 2 of the report, addressing the question of how big a problem is caused by BEPS practices. See OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, at p. 20.

[15] The discussion appears in OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing at p. 36 and then in particular on pp.42-43. The points are again summarised on p.48.

[16] See the discussion in Chapter 5, at p. 52.

[17] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing.

[18] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p.10.

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and relevant substance is needed" and, in the context of the transfer pricing rules" this is explained to require "that the rules should be improved to put more emphasis on value creation in highly-integrated groups, tackling the use of intangibles, risk, capital and other high-risk transactions to shift profits".[19] In the discussion of the transfer pricing actions, there is once again a reference to MNEs being able to use or misapply those rules "to separate income from the economic activities that produce that income and to shift it to low-tax environments". This is followed by the general heading referring to actions 8, 9 and 10 of the action plan which is entitled "Assure that transfer pricing outcomes are in line with value creation". The explanation of the three action points includes the statement that the rules to be developed on intangibles will ensure that the profits associated with the transfer and use of intangibles "are appropriately allocated in accordance with (rather than divorced from) value creation". On risks and capital, the rules will be developed "to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation."[20] The term value creation is referred to throughout the discussion of transfer pricing.

It therefore seems clear that the Action Plan uses the notion of value creation in the context of the transfer pricing rules to refer to the location where business activities are actually taking place and by way of emphasising the contrast to the (often no- or low-tax) locations where the relevant profits arising may be booked.[21] This is intended to highlight the techniques used by MNEs (and in particular the use of a variety of intra-group contractual arrangements that are not aligned with substantive activities) to achieve this result. The ultimate purpose for doing this in the BEPS project was of course driven by the goal of increasing the significance for transfer pricing purposes of what may be termed real business or economic activities as compared with mere formal or contractual booking

[19] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, pp.13-14.

[20] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, pp. 19-20

[21] Though the term is used in the context of the transfer pricing rules, this does not mean that the issues being addressed through the value creation notion are of no relevance to other action points. Those action points may also be relevant to arrangements that are designed to separate profits from the activities that gave rise to those profits. For example, the work on the digital economy restated the point that profits should be taxed "where economic activities deriving the profits are performed and where value is created" (See (OECD 2015) Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report at p. 17. The identified policy objective of the CFC rule in Action 3 (See (OECD 2015), Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report, at pp. 13-14) is to function as a deterrence effect, both complementing the transfer pricing rules by functioning as a partial "backstop" to those rules and also helping reduce incentives for profit shifting out of source jurisdictions. Similarly, the approach under Action 4 on interest deductibility is expressly intended to limit net interest expense to a measure of the taxable income generated by the economic activities of an MNE (see (OECD 2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report, p.12). Action 5 also puts a significant emphasis on the location of substantial activities, both in the specific context of IP-regimes and more generally, and the report states that this is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. (See (OECD 2015) Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report, Chapter 4, paragraph 24.) Action 6 on treaty benefits is intended to combat the use of shell companies with little substance (see OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing at p. 13) and Action 7 adopts what is essentially an activities -based approach to: lower the dependent agent threshold test; reverse fragmentation arrangements; and counter what it considers the artificial avoidance of PE status by the splitting up of contracts (See (OECD 2015) Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, at pp. 15-27 and 39-44). The Action 13 report on transfer pricing documentation draws heavily on measures of substantive activities in the framing of the country by country reporting template (See OECD (2015) Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report, at pp.29-35). This potentially wide relevance of the notion of value creation as it is used in the BEPS project underlines the very broad issues raised by questions relating to the "relevant substance" in the international tax system. Indeed, by the time of the Interim Report, the task of aligning taxable profits with value creation had been recognised as the primary objective of the BEPS initiative: "the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project consisted of 15 separate action areas targeting the gaps and mismatches in the international corporate tax system that facilitated the shifting of profits by multinational enterprises (MNEs) away from where the underlying economic activity and value creation took place". See OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, (OECD Publishing, 2018), pp. 17-18.

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arrangements, thereby reducing the potential for any segregation of where profits are generated and where they are booked.[22]

The interpretation suggested above is confirmed by the later discussion in the Action Plan document relating to Action 11. Here, the discussion repeats a conclusion from the earlier BEPS report (where the term value creation was not used) and re-states it in terms which now refer to value creation: specifically, the earlier discussion in the previous BEPS report is summarised in the Action Plan by the statement that academic studies show "an increased disconnect between the location where value creating and investment activities take place and the location where profits are reported for tax purposes". Comparing the two versions of the discussion, it seems clear that the term value creation is simply presented as another way to refer to "business activities" in the overall proposition that is being advanced that the allocation of profits should be aligned with business activities/ value creation.[23] The Action Plan not only recommends measures to bring about such alignment but also proposes monitoring measures that "should include outcome-based techniques, which look at measures of the allocation of income across jurisdictions relative to measures of value creating activities…".[24]

The use of the term value creation in this context (which amounts to an attempt to fix a core problem of the transfer pricing rules) seems entirely sensible. At a rhetorical level, the connotation of the phrase value creation draws attention to the sharp contrast with any different location where profits may be booked. This is presumably the point of using the words in this way.

An analysis of the term value creation in the context of the Action Plan alone might suggest that the use of those words in the Action Plan is intended to refer to something that approximates to functional activity, i.e. people functions or conduct. Such an interpretation would be consistent with the most fundamental changes contained in the BEPS transfer pricing package, where recourse to the actual conduct of the parties is relied on to transform the approach to the accurate delineation of transactions including the manner in which the reward for risk is allocated;[25] as well as being of significantly increased relevance in the context of the ownership and development of intangibles.[26] However, the subsequent use of the term in the BEPS project, and including especially as profiled in the title of the final report on transfer pricing (Aligning Transfer Pricing Outcomes with Value Creation), suggests a wider meaning not strictly tied to functional activity alone but rather more akin to what is comprised in the "functional analysis" routinely used in transfer pricing, namely requiring consideration of the relevant functions performed, assets used and risks assumed.[27] This would therefore include not merely what the parties actually do but also, and drawing on the explanation in the Transfer Pricing Guidelines, "the capabilities they provide".[28] This broader use of the term

[22] According to the Action Plan, this is the "realignment of taxation and relevant substance [that] is needed" – see the discussion in the preceding paragraph.
[23] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p. 21
[24] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p. 21.
[25] (OECD 2015), Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, at pp.15-38.
[26] (OECD 2015), Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, at pp.63-139).
[27] See for example (OECD 2015), Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, at p.66 (paragraph 6.3). It is specifically clarified in a footnote that the reference to the assumption of risks refers to the application of the guidance in Section D.1.2.1 of Chapter I, taking into account control over risk as well as financial capacity to assume the risk. The financial capacity to assume risk is not predicated on an analysis of functional activities. The discussion of the financial capacity to assume risk is relatively brief in the BEPS final report on transfer pricing but is also considered in the later OECD report on financial transactions – see OECD 2020, Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris, at p.31. The BEPS project increased significantly the relevance of functional activity or conduct in a transfer pricing context but there was never the appetite to go so far as to rely wholly on such functional activity and to wholly ignore contractual allocations of capital and risk.
[28] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 1.51. However, as will be explored further below, the reference to "capabilities" would need to be interpreted broadly to include account being taken of matters such as the legal rights of the parties, the attributes and behaviours of markets, etc.

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seems to accord with the way the term value creation was used in the earlier (and pre-BEPS) 2012 Discussion Draft on Intangibles.[29] Nonetheless, the purpose behind the use of the term throughout the BEPS project remains designed to emphasize the contrast between locations where real business or economic activities take place[30] and locations where profits may be booked based on mere formal or contractual arrangements.

It is concluded that the point that is being made by the use of the term value creation (and the reason why that particular term is used) does seem reasonably clear, though the term is not defined and seems somewhat imprecise in its scope. This is a matter on which I have more to say below.

(2) Does the notion of value creation have a firm basis as a principle in the international tax system?

This question relating to the basis of value creation in the international tax system is intended to address the degree to which the term has previously been used in articulations of the principles or operation of the international tax system. In relation to the highlighted or stylized use of the "value creation" words themselves, that question can be answered succinctly: prior to 2012 and the BEPS project, the term was not used or deployed in the manner seen in BEPS. It had not previously been used in the same way in previous OECD (or, and going back further in time, League of Nations) documents.[31]

However, while the "value creation" label had not previously been deployed in the highlighted manner first seen in the BEPS Action Plan, the underlying problem that is denoted by the use of that term in BEPS has been a staple of the discussion of the transfer pricing and profit attribution provisions for a very long time. That problem is of course the ability of MNEs to transfer profits to low tax zones, in the process separating the location of profits from the location of business activities.[32] This ability is significantly facilitated by two factors: first, MNEs are able to enter into a wider range of agreements than third parties and, second, the OECD Transfer Pricing Guidelines (and earlier guidance) have explicitly followed a transactional approach and generally required that governments defer to the description of the relevant transactions contained in taxpayer contracts.[33]

This issue was recognised more than forty years ago in the first OECD transfer pricing report, which was published in 1979.[34] That report noted the greater variety of contracts that could be entered

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[29] See, for example, Discussion Draft, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, OECD: Paris, 6 June 2012 at paragraph 108. The Discussion draft is referred to further below.

[30] The reference to economic activities is derived from the explanation in the OECD's explanatory statement on the BEPS project where it is stated that "The combined report…ensures that transfer pricing rules secure outcomes that better align operational profits with economic activities which generate them". See OECD (2016), BEPS Project Explanatory Statement: 2015 Final Reports at p. 15.

[31] A fuller discussion of this point relating to the historical absence of any mention of value creation is presented in Rasmi Das, The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights? Bulletin for International Taxation 2020 vol 74 (3) at section 4.

[32] This is a long-standing problem. For example, there is already in 1933 a reference in the Carroll report on income allocation to the use of "some local subsidiaries as "dummies" or fictious entities designed to set up artificial legal barriers in the way of the assessment of true profit". See Mitchell B Carroll, Taxation of Foreign and National Enterprises, Vol. IV, Methods of Allocating Taxable Income, Geneva, League of Nations, 1933, C.425 (b). M. 217 (b).II.A at p. 60.

[33] See further R. S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, at 6.09 which also discusses how the BEPS project sought to address this issue. It might also be argued that the latitude accorded to MNEs in relation to intra-group movements of capital and capital structure generally is also a major factor in facilitating the ability of MNEs to transfer profits to low-tax zones. Issues relating to capital are discussed later in this article.

[34] Transfer Pricing and Multinational Enterprises, Report of the OECD Committee on Fiscal Affairs, Paris: OECD, 1979. The comments here discuss the position in relation to the work of the OECD over the last forty years. The discussion in the

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into by related parties in comparison with unrelated parties and also noted the ease with which such contracts could be altered, suspended, extended or terminated, including by retroactive actions: The result is that tax authorities would need to determine what is the "underlying reality" behind a related party contractual arrangement in considering what an arm's length price would be.[35] Similar points about the use of contractual arrangements to shift profits relating to intra-group transfers of intangible property and the need to check the "underlying reality" behind an intra-group service contract are also made in the report.[36]

The historical response to this situation on the part of the OECD and tax authorities has involved a number of counter measures. These include the development of the recognition/ recharacterization doctrine which in certain circumstances is intended to permit the re-writing of related party contracts,[37] the use of greater transparency and reporting measures to address the asymmetry of information problem,[38] and, more recently, the adoption of measures that take account of post-transaction information.[39] However, the dominant response has been the focus on the functional activities undertaken in any particular case as a mechanism to prevent, or at least limit, profit shifting by mere contractual arrangements.[40] The first emphatic instance of this in an OECD report followed shortly after the 1979 report, though in the context of the attribution of profit to permanent establishments rather than transfer pricing, specifically in the 1984 report, The Taxation of Multinational Banking Enterprises.[41] The report responded to the issue of "loan parking", which had surfaced in the late 1970s. The concern was that profitable loans were being originated in one jurisdiction but then booked in overseas tax haven locations. The 1984 Report proposes a functions-based approach to the attribution of such loan assets , based on the location where the loans are "substantially generated" by the functional activities of the permanent establishment concerned.[42] The discussion in the report sets out various different types of functions that would be relevant in this regard.

The 1984 report provides an early indication of the highly functions-driven approach that would later be developed by the OECD in the BEPS report in which the value creation notion was mobilised. However, this focus on functional activity was continually revisited and developed in a number of OECD reports in subsequent years, long before the BEPS project. A 1994 OECD report on the attribution of income to permanent establishments, for example, called on enterprises "to frame

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comprehensive analysis of Langbein and Fuss argues for a relevance of the concept of value creation going back to the founding of the international tax system in the 1920s. See S. Langbein and M. Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409 at p. 363.

[35] Transfer Pricing and Multinational Enterprises, Report of the OECD Committee on Fiscal Affairs, Paris: OECD, 1979 at pp.19-20.

[36] Transfer Pricing and Multinational Enterprises, Report of the OECD Committee on Fiscal Affairs, Paris: OECD, 1979 at pp.48,80.

[37] The current approach is contained in OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at pp. 77-80. The approach was altered significantly by the BEPS transfer pricing output. The changes are discussed in R. S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, at 7.43-7.47.

[38] The relevant BEPS output in this area is OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report, OECD Publishing, Paris.

[39] See (OECD 2015), Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, at pp. 107-112. The pre-BEPS view of the acceptability of relying on information on post-transfer profitability was very limited, relating to situations where independent parties would adopt price adjustment clauses. BEPS materially changed this approach.

[40] It may be debated whether this focus on conduct is an anti-avoidance response or a mechanism to identify the real nature of the transaction entered into by the parties, though it is certainly motivated in part by anti-avoidance concerns.

[41] The Taxation of Multinational Banking Enterprises, contained in the volume Transfer Pricing and Multinational Enterprises, Three Taxation Issues, Paris: OECD, 1984.

[42] The Taxation of Multinational Banking Enterprises, contained in the volume Transfer Pricing and Multinational Enterprises, Three Taxation Issues, Paris: OECD, 1984 pp. 68-9.

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their internal agreements in the light of the functions really performed by the different parties rather than resort to legal artifices that tend to suppose a contractual relationship which in no way reflects economic reality".[43] A similar perspective is reflected in the first version (1995) of the OECD's Transfer Pricing Guidelines.[44] The focus on functional activity was also seen, and in a very emphatic manner, in the long-running OECD project on the attribution of profits to permanent establishments in the period 1997-2010.[45] In that report, the location of functional activity – "people functions" - is made decisive in identifying the location of assets, risk and, indirectly, capital, as well as in determining whether internal "dealings" should be recognised at all.[46] The focus on functional activity was also seen in the 1998 report on harmful tax competition, where the lack of substantial activities to support the booking of profits in a low tax environment was taken to be one of four factors adopted to identify a tax haven for the purposes of that report and also indicative of a harmful tax practice.[47] The major OECD project on business restructurings from 2005 which led to a new chapter of the Transfer Pricing Guidelines in 2010 further developed the theme.[48] The new chapter includes extensive discussion of the need to examine the conduct of the parties to ensure its consistency with the relevant contractual arrangements, thereby checking whether the contractual terms have been followed or are a sham. There is a discussion of the functional control of risk and it is also stated that the parties conduct is the best evidence as to the true allocation of risk.[49]

Finally, the importance in the transfer pricing analysis of functional activity is a major theme in the initial discussion draft on intangibles, which was released in June 2012, a few months before the BEPS project started.[50] The discussion in that document is peppered with references to both value creation and the creation (and contribution) of value though the term "value creation" is not presented in the more stylized manner adopted by the BEPS project. In the introductory comments to the paper, for example, it is noted in connection with the functional analysis that "it is especially important to ground the analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value" and again "The functional analysis should identify the economically significant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value."[51]
The importance of the functional analysis is highlighted throughout the discussion, including a highlighted commentary box that includes the statement that legal ownership and the bearing of costs does not necessarily lead to any entitlement to a return from intangible property. Rather, returns "should follow the contributions to the value of the intangibles" and compensation of the

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[43] Issues in International Taxation No. 5, Model Tax Convention: Attribution of Income to Permanent Establishments, OECD: Paris, 1994, p.16.
[44] See, for example, OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris, 1995, at 2.26 which recommends a functional analysis as a possible mechanism to determine the "true function" of an intermediate company: In the event that "it cannot be demonstrated the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods" the corresponding purported profits of the company would "reasonably be attributed elsewhere in the MNE group".
[45] OECD, 2010 Report on The Attribution of Profits to Permanent Establishments, OECD, Paris, 22 July 2010
[46] See OECD, 2010 Report on The Attribution of Profits to Permanent Establishments, OECD, Paris, 22 July 2010, Part I at paragraphs 9-38. A similar analysis is presented in the case of certain specific financial sector businesses in Parts II (banks), Part III (financial sector global trading) and Part IV (insurance business).
[47] See Harmful Tax Competition , An Emerging Global Tax Issue, at pp. 22-25, 34-35
[48] The work led to the insertion of a lengthy new chapter in the Guidelines, Chapter IX, entitled Business restructurings.
[49] See further the 2010 version of the Transfer Pricing Guidelines at paragraphs 9.11, 9.13-9.16, 9.20, 9.22-9.28, 9.36-9.38, 9.85. (The version of this material in the 2017 edition of the Guidelines has been updated to take account of the BEPS changes). The discussion on this point generally foreshadows the themes that are developed subsequently in BEPS, though the contrast with BEPS also highlights the significant and rapid shift engendered by BEPS in the degree to which contracts are to be respected for transfer pricing purposes.
[50] Discussion Draft, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, OECD: Paris, 6 June 2012.
[51] See at paragraphs 3 and 11. There are specific references to value creation in paragraphs 9, 68 and 108.

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various functions, assets and risks of the MNE group should be "consistent with the intangible value they create".[52] There are also lengthy discussions of the relevance of functions in developing, enhancing, maintaining and protecting of intangibles[53] as these functions "may have a material effect on the value of the intangible" as well as a discussion on the need to check whether the parties' conduct indicates that the legal forms and contractual terms have not been followed".[54]

What is demonstrated by this catalogue of pre-BEPS OECD reports discussing the significance and role of functional activity in the income allocation exercise is that, although the value creation notion was highlighted and given impetus only during the BEPS project, the substantive underlying problem (which is clearly a significant problem) is as old as the ALP itself. This raises the question whether it is helpful for that problem of the segregation of profits and activities, and particularly for the measures that are intended to respond to that problem, to be packaged up and considered in terms of a purported "value creation" principle or paradigm.[55] This leads to the last question that is considered here.

(3) Is it helpful to posit value creation as a paradigm or principle for interpreting or applying the arm's length principle (ALP)?

It seems difficult to argue with the notion that, in the BEPS context of trying to devise improvements to the operation of the existing transfer pricing rules (as opposed to conceptually re-thinking the current approach to income allocation in a more fundamental way), it is a high priority to counter the use of booking or contractual arrangements that artificially shift profits to no- or low-tax locations. The question is therefore not about the ultimate *objective* that is often ascribed to the value creation endeavour, but rather about whether the use of the notion of value creation is helpful to that endeavour. To address that question, it is important to understand what use is being made of, or proposed for, the notion of value creation.

There are two immediate possibilities for the use of the value creation notion. First, it might be argued that value creation is a paradigm or principle of (i.e. that describes) the existing income allocation system. Alternatively, the term might be deployed in a normative context, as a recommendation for the future direction of the income allocation system.

It does seem clear that the value creation notion is used in the BEPS project in the latter sense, namely as a normative basis for future direction, i.e. referencing that profit allocations *should* align – or be modified to align – with the notion of value creation, with the goal of the BEPS project being to make significant progress down such a path.[56] This interpretation seems to follow from the stated purpose of the BEPS Action Plan discussed above, namely to deliver the "realignment needed"

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[52] Discussion Draft, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, OECD: Paris, 6 June 2012, p.12.

[53] See paragraphs 29, 37, 38-41 and 48-52. These are the DEMP functions that, with the later addition of the functions of exploitation in BEPS would become the well-known DEMPE functions – see Transfer Pricing Guidelines, Chapter VI Section B.

[54] See paragraphs 30-37 and 40-41. See also paragraphs 42 and 44 in relation to contracts and risk. The discussion of the consequences of a misalignment between conduct and contract in paragraphs 54-55 and 65 is also relevant.

[55] The comprehensive analysis of value creation advanced by Stanley Langbein and Max Fuss adopts, broadly, a defence of the use of value creation as a valid expression of the underlying purpose of the international transfer pricing regime. See S Langbein and M Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409.

[56] On this basis, the term is not appropriately used to describe the existing system, a point made in strong terms by Jonathan Schwarz: "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." See J. Schwarz, Value Creation: Old wine in new bottles or new wine in old bottles, Kluwer International Tax Blog (21 May 2018).

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relating to the ALP.[57] It is also confirmed in the Explanatory Statement given following the release of the Final Reports: "the adoption of the BEPS package … will lay the foundations of a modern international corporate tax system under which profits are taxed where economic activity and value creation occurs".[58]

However, some claims for value creation position the notion as a paradigm or principle of the existing system.[59] Further, it is helpful in considering any normative role for value creation to assess its relevance to the system as it currently stands. Therefore, before proceeding to consider the usefulness of a possible normative role for value creation, some consideration is given to the proposition that value creation is a useful or helpful paradigm or principle of the existing system.

Value Creation as a Paradigm of the Existing ALP System

If value creation is to be a valid paradigm or principle of the existing transfer pricing system, then that notion would need to represent a basic idea or model that explains the elements of the existing system. The immediate difficulty, however, is that there are various instances in the existing system (whether before or after the BEPS project output) where the notion of value creation seems to have no relevance. As discussed earlier, it is true that there is in the existing transfer pricing system a significant reliance on people functions and conduct and the wider functional analysis to support income and profit allocations. These elements might collectively be conceived as the economic activities that represent the bedrock of a value creation approach. However, the current transfer pricing system does not reward uniformly by reference to such economic activities – value creation. The point may be illustrated by reference to the core elements of the Action Plan agenda for the transfer pricing work, namely capital, risk and intangibles.[60]

On capital, the Action Plan clarifies that the goal of the BEPS transfer pricing work was to ensure that inappropriate returns would not accrue to an entity solely because it has provided capital. Instead, the objective was to ensure the returns would align with value creation. The discussion referred in particular to the problem of the "over-capitalisation of lowly taxed group companies".[61] This is the issue that is often described as the problem of "excess capital" or "gifted capital" and relates to the transfer of capital to low-taxed, low function, entities by way of equity injection.[62] Notwithstanding the direction in the Action Plan, the BEPS work on capital was unable to define the meaning of excessive capital or establish rules to determine an appropriate level of capital or rules to re-allocate capital amongst associated enterprises or consider whether and how the ALP might be applied to cross-border transfers of capital between related entities. One consequence of this was that the work on capital retrenched to a determination of the appropriate return to a capital provider or funder under the ALP. This work was intimately tied to the work on risk (which is considered further below). Under the approach developed in BEPS, the return to a capital provider is made dependent upon the level of risk assumed by that entity in making the investment. However, where the funding entity does not perform any of the relevant functions related to the control of risk, it is still entitled to a risk-free rate of return (corresponding, broadly, to the return on a high-quality government

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[57] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, pp.13-14.

[58] OECD, *OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement – 2015 Final* Reports, (OECD Publishing, 2015), OECD, p. 9.

[59] It might also be argued that the changes to the transfer pricing rules made by the BEPS output *create* a value creation-based transfer pricing system.

[60] Actions 8 is concerned with intangibles and Action 9 with risks and capital. Action 10 is concerned with remaining other high-risk transactions. See OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, pp.20-21.

[61] OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p.20.

[62] For a discussion of this issue see R. S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, at 5.05-5.12 and 6.37-6.42. It is notable that similar difficulties do not arise in an Article 7 context where the authorised OECD approach (AOA) is adopted because in that case capital is allocated indirectly by the general reliance in the AOA on "people functions".

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bond).[63] It seems difficult to reconcile these examples with an explanation of the current treatment of capital in wholly value-creation terms.

Turning to the treatment of risk, this might be argued to be the centrepiece validation of the value creation approach, particularly given the fundamental role of the new six-step risk framework in the process for the basic delineation of transactions.[64] However, the approach to risk raises a rather different concern, namely whether it conforms to the arm's length principle. In seeking to align the place of income reporting and the place of value creation, the BEPS output on risk requires that an associated enterprise that contractually assumes a risk must actually "control" that risk.[65] The nature of "control over risk" is discussed at substantial length by reference to functional activities that are involved. Making the control of risk a mandatory feature before risk bearing will be recognised for the purposes of the transfer pricing rules assumes that third parties always control the risks they bear. A number of commentators have questioned whether this is correct.[66] The difficulty can be seen in cases where specialist service providers or sub-contractors are employed by a principal to manage certain risks borne by that principal. In such cases, it may seem doubtful whether the principal could properly be regarded as itself "controlling" the risk in question.[67] Further, a lesson from the COVID-19 crisis might be that some economically significant risks cannot realistically be identified in advance and are therefore in practice uncontrollable.[68] It is obviously problematic if a purported principle or paradigm of the transfer pricing system is encapsulated in measures that seem at odds with the ALP itself.

The goals for the BEPS work on intangibles included ensuring that the profits from the transfer and use of intangibles are appropriately allocated in accordance with value creation.[69] This was addressed by several significant changes which generally seek to align the location where the profits from intangibles should be taxed with the location where there are functional activities carried on, and assets used and risks assumed, which give rise to those profits.[70] This is entirely consistent with a value creation approach. Nonetheless, the intangibles discussion reminds us of various matters that need to be taken account of in arriving at an appropriate return relating to intangibles and that seem less obviously – or less helpfully - explicable in value creation terms. For example, contractual rights created by the terms of a contract may in themselves generate significant value.[71] This includes terms such as exclusivity arrangements, renewal options, the geographical scope of legal permissions, or the extent and duration of legal protection, etc. Significant value might also be generated by the grant of government licences to exploit specific natural resources or public goods,

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[63] (OECD 2015), Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, at Paragraph 1.103. A risk-free return is not defined in the Final Report but is discussed in more detail in OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris, at 1.108-1.116.

[64] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 1.60.

[65] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 1.56-1.60. The relevant party must also have the financial capacity to assume the risk.

[66] This issue was debated during the public consultations on the BEPS proposals and a number of commentators suggested that there are numerous situations in dealings between independent parties where the incidence of risk is separated from control over risk. See, for example, Gregory J. Ballantine, Ownership, Control, and the Arm's Length standard, Tax Notes International, 6 June 2015.

[67] An example involving a fund manager is discussed later in this article.

[68] The risk framework assumes that economically significant risks will be identified with specificity - see OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 1.71-1.76.

[69] Action Plan, p.20.

[70] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 6.4.

[71] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at para 6.8, 6.24-25.

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such as a licence of bandwidth spectrum.[72] The return from such legal rights can, as the intangibles guidance makes clear,[73] be policed by resort to the conduct of the parties – in other words by reference to the functions performed, assets used and risks assumed – but the source of the value in this case seems less helpfully described as some aspect of value creation. Similarly, it is also recognised that there are various other features that may contribute value and so would also need to be taken account of. These include matters that would normally be dealt with as part of the comparability analysis, and include, for example, group synergies[74] and various market-specific characteristics such as the buying-power in a market, market behaviours, low labour costs, favourable weather conditions, etc.[75] Again, encapsulating all these features as an aspect of value creation seems awkward and inappropriate, if not unhelpful.

Part of the difficulty is that in these cases the notion of value creation is being used in a different way. Where, as in the usual case, there is an assessment of the functional conduct of an entity (together with a consideration of the assets it uses and risks it assumes) in order to determine an appropriate return from intangibles for that entity, there is (or should be) a correlation between the relevant functions performed, assets used and risk assumed, taken together, and the value thereby created. The value created flows from the activity, at least to some degree. This correlation is absent in cases where value is created by such things as terms in legal agreements or by market-specific characteristics.[76] Nonetheless, defenders of the value creation approach would presumably maintain the value creation approach remains relevant in such cases. This would seem possible only if it is argued that the carrying-on of some kind of value creation activity by an entity is to be regarded as a pre-condition for that entity to be regarded as entitled to the relevant returns – returns that derive from something other than the "value creation" activity itself. There are two immediate difficulties with this. First, the lack of any direct correlation between the (value creation) activity itself and the value or return that is derived (say, from the market-specific features discussed) makes it difficult to apply this variation of the value creation approach in practice. This is because of the difficulties (or, possibly, arbitrariness) in determining what purported value creating activity should properly be regarded as the required pre-condition for accessing the relevant return. This suggests that the reliance on functional activity as some kind of proxy or pre-condition for the recognition of a return in respect of a given factor of value becomes more difficult to the extent the functional activity is removed from, or entirely irrelevant to, the value generated by that factor. Second, whilst the notion of value creation can be used in this way, it seems inapt, and wholly at odds with what might naturally be understood by the plain meaning of the words value creation.

[72] These examples are taken from OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at para. 6.24-5 which also confirms that government licences and concessions are intangibles for the purposes of the guidance in the Transfer Pricing Guidelines.

[73] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 6.42.

[74] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 6.30.

[75] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 6.31. The contribution to value from these factors may be very significant. For example, in relation to market behaviours, the effect of the COVID-19 crisis has led to an almost overnight rocketing of the market price of some highly diverse items such as personal protective equipment (PPE), high-end exercise equipment and puppies.

[76] This suggests a continuum between, at the one extreme, cases where functional activity is itself the primary source of the value-add and , at the other extreme, cases where the value add is derived from factors that have little or nothing to do with production-side functional activity. In the middle, would be cases involving, for example, risk and capital where the relevant functional activity might be allied with, say, the capacity to bear risk (in the case of a decision to assume a risk) or the availability of capital to be deployed (in the case of a decision to commit capital) to create a value add from the combination of the functional activity together with the available financial capacity or capital.

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Based on the above discussion, it is concluded that "value creation" does not qualify as an appropriate principle or paradigm of the existing transfer pricing system.

Value Creation as a Normative Standard

This takes us to the last major point to be considered here. Is it helpful to posit value creation in a normative sense as a paradigm or principle for applying the arm's length principle? It is thought not, for a number of reasons that are discussed below.

Fundamentally, the term seems inapt. The connotation of the term (especially given the use of the word "creation") is suggestive of functional activity yet it seems clear from the above discussion that other factors such as capital, contractual rights, market attributes and behaviours, etc. should also be taken into account in determining an appropriate reward under the transfer pricing system. There is also the point discussed immediately above about the difficulty of using the notion of value creation in relation to items of value that are not obviously related to the value creation *activity* itself. If it is argued that all these items fit within the notion of value creation, it seems the term is being interpreted with such latitude and breadth that it is thereby rendered vague and uncertain, making any claim that value creation is some sort of "paradigm" or "principle" of the existing system somewhat empty. In any event, it is not obvious what particular new meaning or perspective that notion brings.

The last point leads to an obvious problem with the notion of value creation, namely that it is just too vague. The term is used recurrently but not explained by the OECD. This gives rise to a number of separate difficulties.

First, there is a fundamental concern that the term does not shed any light on what business or economic activities are to be regarded as relatively more important than others.[77] For example, does the notion of value creation help us with the task of allocating a return that is derived from the combined contribution of various parties as follows: party A that controls risk, party B that provides capital and party C that performs sales, R&D or production functions? It seems very hard to conclude that it does. This is a particularly important point because it goes to the heart of whether the notion of value creation represents a viable tool or approach that can be applied readily and that might be an improvement over current practice.[78] However, arguably the best that can be said is that measuring value contributions is no easier than the current approach of seeking to identify comparable returns. Finding appropriate comparables under the existing approach to applying the ALP is well-known to be an area of acute difficulty.[79] However, there is at least a good understanding of what is being attempted in the exercise. Yet there is no corresponding understanding of how, in principle, some notion of value creation might likewise be applied – for example, so as to determine the relative value of the different contributions of parties A, B and C in the example above. This is because there is no clear agreement what the term precisely

[77] This suggests that the notion of value creation may be more useful to emphasize the *non-alignment* of profits and value-generating activities rather than as a tool to deliver that alignment, a point echoed by Pascal Saint-Amans, Head of the Centre for Tax Policy and Administration (CTPA) at the OECD at the 2019 IFA Congress – see M. Devereux, "The OECD Pillar One Proposal", *Centre for Business Taxation Blog*, 22 October 2019.

[78] It is recognised that it might be argued that existing approaches – such as the determination of returns based on identified comparable transactions or comparable business operations – could - or should - be subsumed within some broader notion of value creation. This is a possible approach but it would likely dilute materially the significance of any value creation approach, meaning that in large measure value creation is the approach that is currently applied to determining returns.

[79] For a discussion of the practicalities of identifying information on comparable transactions and comparable business operations, see R. S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, at 4.45-4.62.

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means.[80] For example, there is major uncertainty as to whether it is to be regarded as a "supply" or "production" side concept or whether it can also apply to a "demand" side perspective, or indeed both.[81] These practical difficulties are evident in attempts to identify the appropriate measure of return to "user contributions" in the ongoing work on the digitalisation of business. Even those promoting the relevance of value creation seem to accept the thinking on value creation needs significant further development.[82] It may be concluded that these problems entailed in practical measurement contexts are highly significant.

Second, the vagueness means that the term is highly malleable and can be pressed into service in a range of different contexts and to support a range of different matters that seem far removed from the context for which the term was originally intended.[83] For example, the term is used in a rather different sense in the OECD's 2018 Interim Report on Digitalisation, namely as a concept in economic theory, with roots in a firm's "value chain".[84] The notion of value creation has also been used to justify proposals to address the digitalisation of business, which would clearly involve a material extension of its use from that seen in the BEPS project. For example: "It [the European Commission's proposal for a turnover tax] remains fully grounded on the most basic principle of corporate taxation – namely, that profits should be taxed where value is created".[85] The UK has also justified its user participation proposal to address the digitalisation of the economy on similar grounds and again by reference to value creation.[86] In that context, the suggestion that value creation justifies the allocation of corporate profits to unrelated parties (i.e. users) seems hard to reconcile with the ALP.[87]

Third, a further aspect of the vagueness in meaning of the term is that its application might lead to conflicting results. This can be seen in an example that illustrates the collision of two OECD texts which arguably each represent the essence of the value creation approach (and specifically identify a pre-eminent role for functional activity), namely the BEPS discussion of risk and the approved OECD approach to the attribution of profits to permanent establishments ("the AOA"). In the BEPS analysis of risk in the final transfer pricing report, there is a discussion of the position of an investor that appoints a discretionary investment manager to manage its investments.[88] The investment manager makes day to day buy and sell decisions relating to the investment portfolio but the risk of loss would be borne by the investor. The conclusion reached is that the investor is controlling its risks through its decisions to hire and retain the fund manager, and its decisions as to the degree of authority given to the fund manager and the amount invested. The consequence is that the investor retains control of the risk in the portfolio and would be entitled to the return on the portfolio after paying a fee to the fund manager for its provision of

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[80] See for example IMF, *Corporate Taxation in the Global Economy*, 22 January 2019, p. 18.
[81] Das, section 1.1, 2.3 and 2.4
[82] S Langbein and M Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409 at pp.365, 394-5, 397-8 and 407.
[83] S. Morse, "Value Creation: A Standard in Search of a Process", at pp. 199-201.
[84] OECD (2018) Tax Challenges Arising from Digitalisation – Interim Report 2018, OECD Publishing, Paris. Chapter 2, by far the longest chapter in the report, is concerned with Digitalisation, business models and value creation. Value creation is seen as arising out of the work of Porter on the "value chain" of a firm which gives the firm competitive advantage (see at p. 35). See further M. Porter, Competitive Advantage Creating and Sustaining Superior Performance, The Free Press, New York, 1985.
[85] European Commission, Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market (21 Mar. 2018), available at: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_18_2141
[86] HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update*, pp. 3-5.
[87] Further, it implies that for the purposes of transfer pricing the relevant functional activity of, say, Google extends beyond its employees in the group to include other actors (such as its users or customers), even though it is clear that at arm's length, Google is able to capture value from these actors without remunerating them in monetary terms.
[88] The relevant discussion is now included in the Transfer Pricing Guidelines at 1.70.

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an investment management service. However, if the example is subject to analysis under the AOA, it seems very hard to resist the opposite conclusion that, because the fund manager is carrying on the relevant "significant people functions", it is therefore entitled to the bulk of the reward from the fund. This is on the basis that it is the fund manager, not the investor, that takes the active day to day decisions relating to the acceptance and management of risk.[89] It is obviously not helpful if what seem to be the cardinal texts espousing a value creation approach cannot readily be reconciled.

Another area of difficulty relates to the assumption that value creation is acceptable to the G20 and so may be of practical use in the forum which is most concerned with advancing international tax policy decisions.[90] However, this seems a doubtful claim given that there is evidently no consensus on the part of delegates to the Inclusive Framework and the Steering Group to the Inclusive Framework that the concept is useful.[91] It might be argued that the notion of value creation is unattractive only to those (non-OECD member) states that harbour reservations about the ALP. However, in the course of discussions during the BEPS project, it is well known that long-standing *OECD member countries* took very different views on the degree to which a departure from contractual arrangements in favour of a return to functions is justified (for example, as seen in the debates on the appropriate return to capital), meaning that there will likely be different views from one state to another on what value creation means or requires. This makes it more difficult for the concept of value creation to be practically useful to OECD and Inclusive Forum delegates.

Even if all the above matters relating to the meaning of the term and the consensus on its use were addressed, there would remain some appreciable practical issues to contend with. These relate to the viability of the functional approach that is promoted by the value creation approach. As is evident from the BEPS project, the value creation approach is not restricted to the use of a functional activity perspective but it clearly places a very significant emphasis on it in its concentration on the actual functional activities or conduct of related parties. This is of course also the approach that is central to the AOA in an Article 7 context. Though it has been given relatively limited consideration in the discussion of the value creation approach to date, there are limits to what is practically possible with this granular, and highly complex, focus on "people functions". These limits are important because the focus on conduct is such a central part of the value creation approach. In the authors experience, and as confirmed by discussions with a number of tax professionals and tax authorities, the capacity from a compliance perspective to accommodate this approach falls far short of what is assumed by the value creation approach. For example, whilst the new risk framework with its forensic examination of the parties' conduct is in theory a staple part of the approach to the delineation of all transactions for transfer pricing purposes, the practical reality is quite different. Tax professionals simply do not have the capacity or resources to actually apply this approach in all cases in practice. Neither do tax authorities have the capacity or resources to police it in all cases.[92] Perhaps it might be argued that all will be well if the new approach is applied as a matter of practice in only the most contentious situations, but that

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[89] See OECD, 2010 Report on The Attribution of Profits to Permanent Establishments, OECD, Paris, 22 July 2010, Part I at paragraphs 15-27. It might be argued that the example should more appropriately be considered by reference to the relevant "key entrepreneurial risk taking" functions (and so by reference to the approach in Parts II and III of the Report) given the financial sector context. However, the answer would remain the same – see Part II at paragraphs 8-10, 16, and 20 and Part III at paragraphs 39-57 and 73-80.

[90] S Langbein and M Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409 at pp. 398-9 and 402.

[91] Rasmi Das, The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights? Bulletin for International Taxation 2020 vol 74 (3) at section 3 which is given over to a discussion of this point.

[92] The difficulties discussed here will increase to the extent the transfer pricing rules continue to be adapted in the manner seen in the BEPS project, i.e. primarily with a view to countering BEPS practices. The significant conduct-based changes to Chapter 1 of the Transfer Pricing Guidelines make it even more difficult for low capacity developing countries to apply those guidelines, and it is hard to believe they were drafted with developing countries in mind.

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would presumably require some ready agreement on what those situations were. The practical difficulties are also multiplied by what is involved in the process of assessing conduct, including for example the difficulties of establishing who ultimately might be regarded as making decisions, what the process of making a decision actually entails, etc when the relevant business processes are complex and there are contributions to the process from a number of different related parties.[93] The short point is that a reality check on what can be accomplished given this explosion of complexity is already overdue.[94]

On top of the issues discussed above, it is also the case that whilst functional activity tests may help in many cases to constrain tax planning structures aimed at exploiting the transfer pricing rules, a reliance on the conduct of the parties may not always achieve its intended goal. For example, the relevant activity test may itself be too malleable or easily arbitraged.[95] This suggests a focus on value creation is too limiting.

Conclusion

This paper addresses three questions relating to value creation. On the first question, relating to what the term "value creation" means or refers to, it is considered that the intended use of the term in BEPS, initially in the Action Plan and subsequently more widely in the BEPS output, is reasonably clear and this use of the term to illustrate the issue of the segregation of profits and booking location makes sense. On the second question, whether there is a basis for the term, the conclusion is that the use of the term in the BEPS project is novel, but the underlying problem the term is being used to refer to is not, and in fact is as old as the ALP itself. On the third question, whether it is helpful to posit value creation as a paradigm or principle for interpreting or applying the arm's length principle, it is concluded that value creation is for a number of reasons not apt to describe the existing transfer pricing system. Also, it is also concluded that neither is the term appropriate or useful as a normative concept that represents some paradigm or principle to be aspired to. The notion of value creation is just too limiting, too vague, too problematic, for all the reasons discussed above.

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[93] Some of these practical difficulties in the context of the AOA are considered in R.S. Collier and J. Vella, Five Core Problems in the Attribution of Profits to Permanent Establishments, World Tax Journal, Volume 11, Issue 2, May 2019.

[94] It is argued in R. S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press at 8.14-8.18 that the problem of complexity remains post BEPS one of the two most significant problems for the future of the ALP. An example of the impact of this point may be seen in the development of thinking in the 2012 Discussion Draft on intangibles. The suggestion in that Discussion Draft that profits from intangibles should be allocated in proportion to the value of each group member's contribution to the value of the intangible (which would have been entirely consistent with the value creation approach) was toned down in the Final BEPS Report, primarily because of practical concerns about how it might be applied in practice and specifically that it might lead to more, not less, controversy. See R. S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, at 6.63.

[95] For example, the relevant functional activity required to manage a handful of intra-group loans may be modest, therefore making the location of that activity, and the profits from those loans, highly mobile. Similarly, though a bank may need a group of, say, 150 people to build a profitable book of business In a state, the risk in that assembled portfolio of loan assets might easily be transferred to a low-tax entity through the use of a derivatives transaction, with the risk in that derivative instrument being managed by, say, two or three people stationed in the low-tax entity. (The example illustrates a point of principle but is over-simplified as in practice there may be a variety of non-tax factors, such as the impact of regulation, that would need to be considered). The examples illustrate the point that the value creation approach is likely to be in any event less effective in relation to money transactions. See further OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report, at pp. 11 and 17.

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