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VALUE CREATION, VALUE CAPTURE, AND VALUE EXTRACTION: WHAT THEORY FOR A NEW INTERNATIONAL TAX SYSTEM?

Debora Ottoni Uébe Mansur

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Value Creation, Value Capture, and Value Extraction:

What Theory for a New International Tax System?

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Abstract

The idea of value creation has pervaded transactional tax discussions since the release of the OECD/G20 BEPS Project. Although recently relinquished as the main justification for the establishment of a new nexus to shift taxing rights to marketing jurisdictions under the Pillar One Proposal, value creation remains the benchmark for the BEPS Project that is still being invoked as the proper response to base erosion and profit shifting issues. The ambiguous meaning of value creation, its relation to corporate income, how to geographically locate its source, and the lack of an underlying scientific theory that justifies its use as a proxy for allocating taxing rights are some of value creation standard's main flaws. Many of the inconsistencies in its logic that is applied to taxation stem from an incomplete understanding of value. If taxation is to track it in order to drive tax allocation, it is necessary to adopt a value theory that encompasses all of the different value manifestations that go beyond the concept of value creation. Such improvement is possible through a comprehensive value theory that adopts the concept of value capture that encompasses not only the notion of value creation but also the equally relevant one of value extraction. A value capture theory would more accurately account for all processes of wealth generation and distribution made possible by cooperation among countries and deliver a truly innovative international tax system.

Keywords

BEPS Project, Pillar One Proposal, allocation of taxing rights, value, value creation, value extraction, value capture, value chains, international tax system.

Introduction

Since the Organization for Economic Cooperation and Development (OECD) launched the Base Erosion and Profit Shifting (BEPS) Project in 2013 with the support of the Group of Twenty (G20), the expression "value creation" has been increasingly pervading international tax discussions, not always in an appreciative way. It became an important benchmark for the 2015 OECD/G20 BEPS Action Plan, including the later 2017 amendments to the OECD transfer pricing guidelines[1]. It has corroborated all of the main proposals for the reform of international tax rules in response to the rise of the digital economy.[2] Although the value creation standard played an important role in the OECD's work regarding the tax challenges arising from digitalization,[3] it has gradually been losing its prominence. It was recently relinquished as the main justification to the establishment of a new nexus to shift taxing rights to marketing jurisdictions under the OECD/G20 BEPS Pillar One Proposal.[4]

The ambiguity of value creation, the lack of a precise definition of value, its relation to corporate income, and how to geographically locate its source are just some of value creation standard's flaws that led to some criticism by scholars. Moreover, there is no underlying scientific theory that justifies the use of value creation as a proxy for allocating income within a multinational group and accordingly distributing taxing rights among jurisdictions.

Despite not unanimous and abandoned by the discussions related to the digitization of the economy, value creation standard has not left the arena of international tax law.[5] "Aligning taxa-

1 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* OECD Publishing, 2017, p. 51, <http://dx.doi.org/10.1787/tpg-2017-en> accessed 20 January, 2022.

2 *See* OECD, *Base Erosion and Profit Shifting Project - Public Consultation Document – Addressing the Tax Challenges of the Digitalization of the Economy,* OECD Publishing, 2019, <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> accessed 15 December 2021. (The 2019 OECD Public Consultation Document on the tax challenges of digitalization mentioned that the three proposals therein included had the same objective of recognizing "from different perspectives, value creation of a business' activity or participation in user/market jurisdictions that is not recognized in the current framework for allocating profits.".)

3 *See* OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project,* OECD Publishing, 2020, <https://doi.org/10.1787/beba0634-en> accessed 01 March.

4 The recently approved OECD/G20 Pillar One solution, that proposes to shift a portion of global tax revenues to "market jurisdictions" by establishing a new nexus to allow source taxation without the need of physical presence does not rely mainly in the assumption that value is created where consumers and users of digital goods and services are located. It relies, otherwise in "active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction". Pillar One Proposal will be further explained in subsection 1.2.

5 *See* Adolfo J. Martín Jiménez, "Value Creation: A Guiding Light for the Interpretation of Tax Treaties?", v.74, Bull. Intl. Taxn. 4/5, IBFD, 2020, p.197-197, <https://research.ibfd.org/#/doc?url=/document/bit_2020_04_o2_6> accessed 20, April, 2022.

tion with value creation" remains the benchmark for the BEPS Project and is still being invoked as the proper response to base erosion and profit shifting issues.

This article contends that many of the perceived flaws in the logic of value creation that is applied to taxation originate from an incomplete comprehension of value. It claims that it is necessary to adopt a value theory that encompasses all different value manifestations that go beyond the concept of value creation if taxation is to track value to drive tax allocation. A better and more complete understanding of value grounded in the non-juridical theories that inspired value creation incorporation by international tax law and an assessment in the role of value in modern international economic activity are necessary for improving the current value system applied to taxation.

The conclusion reached by this article is that, without completely abandoning the idea of taxation according to value, such an improvement is possible through a new and comprehensive value theory. It should accurately account for all processes of wealth generation and distribution made possible by cooperation among countries. It should adopt the concept of value capture that encompasses not only the notion of value creation but also the equally relevant idea of value extraction.

This paper proceeds as follows. Section 1 explains how the idea of value creation arose in the international tax context and became a central tropic in recent global discussions on the proper allocation of taxing rights among countries. It also accentuates the different meanings that the expression acquires throughout the OECD Base Erosion and Profit Shifting Project. Section 2 discusses the inadequacies of the idea of value creation as a sufficient theory for tax allocation and contends that it is not really capable of creating a new international tax system in its current form. Section 3 then proposes a research agenda for adopting a comprehensive notion of value under which taxation is aligned with value capture.

1. Value creation in international tax: The rise and fall of a vague concept

The value creation concept appears to be as popular in international tax law as it is vague.[6] Since its first emergence within the OECD's and G20's BEPS Project, it has been invoked under different meanings to support diverse views on how tax allocation among countries should be carried out[7], but also to drive the interpretation of arm's length principle and the share of taxable profits among enterprises[8] and later on, to underly new nexus proposals.[9]

This section provides a brief historical overview about value creation standard. It explores the different meanings that value creation has assumed over the years and under the two phases of BEPS Project known as BEPS One and BEPS Two. It will also assess the reasons for the standard's rapid rise to popularity and later rejection.[10] In doing so, the section explicates the groundwork for the discussion that follows in the remainder of the paper.

1.1. Origins and BEPS One: The rise

An historical overview of international tax law's main concerns indicates that the intuitive appealing concept of value creation is a relatively recent topic among discussants despite its

6 Johanna Hey, "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative", v.72, Bull. Intl. Taxn. 4/5, IBFD, 2018, p. 203-203, <https://maxlewis.com.sg/wp-content/uploads/2020/04/1-Taxation-where-value-created-Hey.pdf> accessed 19 December 2021.

7 *See* Jiménez, *supra* n. 05, p. 197.

8 Mirna Solange Screpante, "The Arm's Length Principle Evolves Towards a 'Value Creation Functional (i.e. DEMPE) Formula Standard': A Barrier or a Gateway to Locational Business Planning?', v. 48, Intertax 10, p. 861-862, <https://kluwerlawonline.com/journalarticle/Intertax/48.10/TAXI2020087>, accessed 01 May, 2022. *See* also Mindy Herzfeld, "Value Creation, Digital Users, And the History of Things", Tax Notes International, 2018, p.773-776, < https://ww.taxnotes.com> accessed 03, April, 2022.

9 Leopoldo Parada, "The Unified Approach Under Pillar 1: An Early Analysis", Tax Notes International, v. 96, n. 11, No. 11, 2019, <https://ssrn.com/abstract=3522027> accessed 21 February, 2022.

10 OECD's Base Erosion and Profit Shifting Project is usually referred to as having two phases. BEPS One is the initial phase of the project from 2013 on when fifteen actions were developed with the objective to effectively address the opportunities to tax planning strategies that exploit gaps and mismatches in tax rules in order to avoid or decrease corporate income tax liability. The later phase of BEPS, known as BEPS Two, refers to the OECD's and G20's initiatives directly linked to the tax challenges of digital economy, specifically to the release of a document called the Tax Challenges Arising from Digitalization and the following developments of the initiative, i.e. the Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy.

extensive use in different tax contexts[11]. The expression emerged only with the release of the OECD's and G20' BEPS Action Plan[12] and was connected to the call for its alignment with taxation. The rationale that underlies the value creation standard, that is, income taxation should occur where the economic activity that generates the income takes place, has older roots and was developed much before BEPS Project.

The idea of taxing at the place of economic activity can already be found in the early design of the international tax framework through the work of the League of Nations in the beginning of the 20th Century, although with no reliance on "value creation" and no direct reference to the allocation of taxing rights.[13] It was the principle of economic allegiance that first emerged as a nexus justification and therefore a criteria to drive the fiscal allocation of taxing rights between countries[14]. According to the League of Nations'1923 report, there were four elements of economic allegiance: origin of wealth, situs of wealth, enforceability of rights to wealth, and residence or domicile.[15]. Among these elements, origin and domicile were given greater weight as the elements chosen as criteria to apportion taxing rights.[16]

The origin and situs continue to be current the basis for the allocation of taxing rights over international income that informs both the OECD Model Tax Convention on Income and on Capital as well as the United Nations Model Double Taxation Convention Between Developed and Developing Countries.[17] Under both tax models, taxing rights are allocated to source and residence countries grounded on those criteria established by the League of Nations' report in the beginning of the 20th Century.[18]

The expression "value creation" was only introduced in international taxation later on within the framework of the OECD's and G20's Base Erosion and Profit Shifting Project, hereinafter

11 *See* Richard Colier, "The Value Creation Mythology" in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 135.

12 Michael P. Devereux and John Vella, "Value Creation as the Fundamental Principle of the International Corporate Tax System.", European Tax Policy Forum Policy Paper, 2018, p. 04, <https://ssrn.com/abstract=3275759.> accessed 24 April, 2021.

13 *See* Jerome Monsenego, "Value Creation and Transfer Pricing" in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation*, Volume 9, IBFD, 2020, p.109. (According to Jerome Monsenego, the value creation concept of levying taxes where economic activities are performed could be found in the work of the League of Nations both as an attempt to define the source of income in the search of taxation principles and in the discussion regarding apportionment of profits.)

14 League of Nations, Report on Double Taxation submitted to the Financial Committee Economic and Financial Commission Report by the Experts on Double Taxation Document, Legislative History of United States Tax Conventions, Vol. 4 Sec. 1, 1923, <https://taxtreatieshistory.org/> accessed 14 February 2022.

15 *Idem.*

16 Pablo Mahu Martinez, "Distributive Profit Allocation Rules: A New Approach for an Old Problem", v.49, Intertax 2, 2021, p. 144-146, <https://kluwerlawonline.com/JournalArticle/Intertax/49.2/TAXI2021014>, accessed 03 March, 2022.

17 Describing the source and residence taxation and the doctrine of economic allegiance, Adam Becker observes that the League of Nations Report on Double Taxation of 192 has formed the basis for many contemporary principles of international taxation. *See* Adam Becker, "The Principle of Territoriality and Corporate Income Taxation – Part 1: What Territoriality Means and Whether or Not It Guides Country Practice", v.70, Bull. Intl. Taxn 4, IBFD, 2016, p.190-194, <https://research.ibfd.org/#/doc?url=/document/bit_2016_04_int_4> accessed 03 March 2022.

18 Rasmi Ranjan Das, "The Concept of Value Creation: is it Relevant for the Allocation of Taxing Rights?", v. 74, Bull. Intl. Taxn. 3, IBFD, 2020, p. 134-141, <https://research.ibfd.org/#/doc?url=/document/bit_2020_03_o2_2>, accessed 10 February 2022.

called BEPS One.[19] The release of the BEPS Action Plan in 2013 revealed the overall objective to ensure that taxation is levied where economic activities occur.[20] In the introductory comments to the action plan, the OECD mentions the aim of curbing practices that "artificially segregate taxable income from the activities that generate it"[21] in combination with the need of "realignment of taxation and relevant substance".[22] Value creation is explicitly mentioned in the action items regarding the digitalization of the economy (Action 1) and transfer pricing (Actions 8-10). Specifically, Action 1 noted

> the attribution of value created from the generation of marketable location-relevant data through the use of digital and the products and services" as one of the main difficulties posed by the digital economy for the application of current international tax rules. Actions 8-10, in turn, established the goal of assuring "that transfer pricing outcomes are in line with value creation.[23]

Two years later when the Final Reports of the BEPS Actions were published, the alignment of taxation with value creation had become a central benchmark for the entire BEPS Project.[24] Apart from being the main concept for improving transfer pricing as proposed by Actions 8-10, value creation was explicitly mentioned in the introduction chapter of Action 1, whereby "profits should be taxed where economic activities deriving the profits are performed and where value is created".[25] This has been identified as a goal in addressing the challenges of digitalization. Following the BEPS One final reports, amendments to the OECD Transfer Pricing Guidelines were approved in 2017 in order to incorporate the outcomes of Actions 8-10 thus consolidating value creation as a vector for the allocation of profits for income tax purposes.

Although more directly invoked by the actions mentioned previously regarding transfer pricing and the digitalization of the economy, the goal to align taxation with the activities that

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19 Devereux and Vella, *supra* n. 12, p.01.

20 OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, 2013, p. 10, <http://dx.doi.org/10.1787/9789264202719-en> accessed 16 February 2022. (The background of the action plan states that "Over time, the current rules have also revealed weaknesses that create opportunities for BEPS. BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.")

21 *Idem,* p. 10.

22 OECD, *supra* n. 20, p. 10.

23 OECD, *supra* n. 20, p. 20.

24 OECD, *Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project,* OECD Publishing, 2015, <https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf> accessed 16 February 2022.

25 OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2015, p. 17, <http://dx.doi.org/10.1787/9789264241046-en> accessed 24 April, 2022.

give rise to taxable profits is also relevant for issues tackled by other actions of BEPS Project. Some examples of the extensive application of the value creation standard in BEPS One actions are:

- Action 3 aiming to strengthen controlled foreign corporation (CFC) rules to curb practices that separate profits from the economic activity that give rise to them;

- Action 4 limiting interest deduction to a measure that expresses the taxable income generated by an enterprise;

- Action 5 aiming to tackle harmful tax practices through transparency and substance and emphasizing the location of substantial activities; and

- Action 6 that intends to prevent that treaty benefits are used by shell companies with little or no substance.[26]

From the name of the OECD Project whereby value creation expression first emerged – Base Erosion and Profit Shifting – it seems that the call for the alignment of taxation with value creation was a political reaction to some recognized flaws in the international tax system.[27] In order to effectively address this with a system prone to practices that artificially play with intangibles, risks, and capital in order to shift profits low tax jurisdictions and erode tax bases, BEPS One claimed that no value is created in places where no business functions are performed or where there is no economic substance, and thus no taxing rights should be recognized in those places.[28]

None of the OECD reports that used the term value creation provided a clear definition of what it is, and its scope under the work of BEPS One seems to be rather limited. The expression was framed more as a negative tax allocation rule that denies taxing rights to jurisdictions where no economic substance is found.[29] As such, the adoption of value creation as an international standard did not entail an attribution of taxing rights to any jurisdiction apart from those traditionally considered as a source or residence by the rules for taxing rights allocation embodied in the UN and OECD Tax Model Conventions.[30] Taxing rights over passive income are allocated to

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26 For elaboration, *see* Colier, supra n. 11, p. 135. See also Angelo Nikolakakis, "Aligning the Location of Taxation with the Location of Value Creation: Are We There Yet!?!", v.75, Bull. Intl. Taxn. 11/12, 2021, <https://research.ibfd.org/#/doc?url=/document/bit_2021_11_o2_17> accessed 29, April, 2021

27 For a list of reasons for a tax reform, *see* Clemens Fuest, "Taxation in the Place of Value Creation: An Economic Perspective" in in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 97. *See* also Werner Haslehner and Marie Lamensch "General Report on Value Creation and Taxation: Outlining the Debate" in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 12.

28 *See* OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2015, p. 10, <http://dx.doi.org/10.1787/9789264241244-en> accessed 12 December 2021 (containing "revised guidance which [...] ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them").

29 Considering that value creation embodies both a positive and a negative source rule, *see* Jiménez, *supra* n. 05, p. 200.

30 Ranjan Das, *supra* n. 18, p. 143.

resident countries and taxing rights over active income to source countries within the limits of the permanent establishment wherever the value was deemed to be created.[31]

Regarding the allocation of profits within a multinational group and the corresponding distribution of taxing rights among jurisdictions associated with that group, the "value creation standard" had a much larger, although subtle, impact.[32] Actions 8-10 and the following 2017 Transfer Pricing Guidelines indicated that aligning transfer pricing outcomes to value creation was meant to avoid that profits were shifted to low-tax jurisdictions through the manipulation of contractual arrangements that did not accord with the economic reality[33]. It focuses on a more functional approach for the attribution of income within transfer pricing rules. In this sense, a functional analysis should identify the actual contributions of each party to profits generated by the group. This would ensure that no profits are attributed to group entities that do not perform any economic activity and have no economic substance.[34]

Therefore, the value creation standard did not alter the core foundation for transfer pricing rules, specifically the arm's length principle[35], but rather reinforces its anti-avoidance aspect.[36] It strengthens the substance requirement to avoid profit allocation as a mere consequence of contractual allocation of functions, assets, risks, legal ownership of intangibles, provision of capital, etc.[37] Moreover, value creation drives the interpretation of the arm's length principle in a way that profits generated by those functions, assets, and risks are taxed in the country where they are located.[38]

31 Werner Haslehner, "Value Creation and Income Taxation: A Coherent Framework for Reform?" in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 49.

32 For an assessment of the role of value creation standard in transfer pricing, *see* Verena Hahn, Yves Hervé, Salem Saljanin, and Lorraine Eden, "Shapley Value: A Fair Solution to the Value Creation Puzzle In Transfer Pricing?", v. 104, Tax Notes International, 2021, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3969517> accessed 11 March, 2022.

33 Monsenego, *supra* n. 13, p.115.

34 *See* OECD, *supra* n.01, p. 51, <http://dx.doi.org/10.1787/tpg-2017-en> accessed 20 January, 2022 ("In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.").

35 The arm's length standard or principle is the one according to which prices set by a taxpayer in its dealings with related parties need to be the same as those used in comparable dealings with unrelated parties. *See* Brian J. Arnold, *International Tax Primer,* 3rd ed., Wolters Kluwer, 1996, p. 92-93.

36 Screpante, *supra* n. 08, p. 861 ("Actions 8–10 BEPS have attempted to give transfer pricing rules a preeminent role in the assertion of international anti-avoidance standards considering that so much emphasis has been given to the concept of 'substance' for the 'new' concept of value creation.").

37 The guidance for applying the arm's length standard in the Final Report of BEPS Actions 8-10 led to the revision of Chapter One of the OECD Transfer Pricing Guidelines in order to guarantee that transfer pricing outcomes are in accordance with value creation. The goal was to ensure that "actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality; contractual allocations of risk are respected only when they are supported by actual decision-making; capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance; tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply". OECD, *supra* n. 28, p. 20.

38 Monsenego, *supra* n. 13, p. 108.

Two conclusions derive from this analysis regarding both the scope of value creation and its popularity under the work of BEPS One and are described below.

The first conclusion is that aligning taxation with value creation was easily accepted within the work of the OECD BEPS One because it aimed to tackle double non-taxation and base erosion problems. To achieve this, it would deprive low-tax jurisdictions from international tax revenues with a criteria that seemed reasonably neutral.[39] Such a goal would ultimately benefit many countries engaged in cross-border transactions without compromising old internationally agreed tax rules. This was celebrated by the governments of those high income jurisdictions for which double non taxation had become a significant international tax problem.[40] Then, the ambiguity of the value creation standard did not prevent its popularity.[41]

The second conclusion is that even though none of the BEPS One items were intended to change internationally agreed rules on the allocation of taxing rights over cross border income, a problem posed by the Action One of BEPS Final Report on addressing tax challenges posed by digitalization triggered discussions on those allocating rules. The Action 1 Final Report observed that the advent of digital business exacerbates profit shifting practices[42] and that existing nexus rules do not provide an appropriate response.[43] This is because these rules use physical presence as a tax nexus which means that taxing rights cannot be allocated to places where firms are not physically present despite the existence of economic activity therein. Action One pointed out the issue but did not indicate a solution. The task of redefining a nexus was assumed by the OECD Inclusive Framework under a G20 mandate whereby the value creation standard assumed a different meaning which is explored in the following subsection.

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39 Allison Christians, "Taxing according to value creation", v.90, Tax Notes International, 2018, p.1379- 1383, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3230370> accessed 03 March 2022. ("One reason taxing in accordance with value creation has become a readily acceptable principle is that the old intentional tax compromises, designed primarily to prevent double taxation, led the world to a scenario in which double nontaxation became a problem for the governments of high-income nations. Taxing in accordance with value creation seeks to answer this problem with a neutral-sounding process.")

40 *Supra* n. 39, p. 1383.

41 *See* Jiménez, *supra* n. 05, p. 198 ("The rapid acceptance of the expression [value creation] at different levels is probably linked to a phenomenon that is currently very common. Namely, the use of words and expressions in public debates with ambiguous or empty meanings, which are susceptible to accommodate one option and the contrary, but give rise to quick acceptance because of their positive connotations").

42 *See* OECD, *supra* n. 25, p. 11. ("Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multisided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. [...] While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks.")

43 Ranjan Das, *supra* n. 18, p. 134.

1.2. BEPS 2 and the Pillar 1: The fall

The OECD turned the unfinished work of Action One in BEPS One into a novel, standalone project, i.e. BEPS Two.[44] The objective of the new intended reform is to tackle the challenges that the digitalization of economy created for the application of international tax rules that are still based on the League of Nations' 1923 Report. If the OECD was unwilling to discuss the allocation of taxing rights among countries under BEPS One, this is precisely the primary focus now under BEPS Two. A physical-presence tax nexus was acknowledged as no longer appropriate in a world where digitalization enables business to be active in a country's economic life by virtual means.[45]

The BEPS Two work consists mainly in two proposals to reform the tax system: the Pillar One Proposal referring to a new tax nexus that grants taxing rights to marketing jurisdictions[46], which is particularly relevant for this work, and the Pillar Two Proposal that consists of a global anti-base erosion proposal based on a minimum taxation[47].

Among the three main proposals for allocating taxing rights to marketing jurisdictions are the "significant economic presence", the "marketing intangibles", and the "user participation"[48]. The latter two were those that inspired the final Pillar One Proposal[49]. All of them were grounded on the assumption that value is created in the jurisdictions where consumers and users of digital goods and services are located which should entail the attribution of taxing rights to those jurisdictions.[50] They reflect countries' goals to capture value that is claimed to be created in their market by local users or consumers but could not be taxed there under traditional in-

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44 See Nikolakis, *supra* n. 26, p. 558, 559. (Referring to the work of BEPS One Action 1, Nikolakis observes that " [...] the Final Report on Action 1 concluded that no measures should be adopted that are specific to what was then referred to as the digital economy. [...] The Final Report on Action 1 then goes on to discuss how other Actions would address certain of the concerns that arise in this context.[...] Clearly, that was seen as insufficient by certain members of the Inclusive Framework").

45 About a non-physical nexus, *see* Stjepan Gadžo, "New Nexus for the Digital Economy: An Analysis of Digital, Revenue-Based and User-Based Factors in Pasquale Pistone and Dennis Weber (eds), *Taxing the Digital Economy: The EU Proposals and Other Insights*, IBFD, 2019, p.95.

46 OECD, *Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,* OECD Publishing, 2021, <https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> accessed 27 February 2022. (According to the Pillar One Proposal, the in-scope companies for which global turnover is above EUR 20 billion and profitability is above 10% [i.e. profit before tax/revenue] will have 25% of their residual profit defined as profit in excess of 10% of revenue [called Amount A] allocated to market jurisdictions whenever the new nexus is present using a revenue-based allocation key. The new special purpose nexus rule allows the allocation of Amount A to a market jurisdiction when the in-scope MNE derives at least EUR 1 million in revenue from that jurisdiction. For smaller jurisdictions with a GDP lower than EUR 40 billion, the nexus will be set at EUR 250 000.)

47 *Idem.* (Pillar Two Proposal encompasses the called Global Anti Base-Erosion [GloBE] Rules that are two domestic rules aiming to guarantee an effective tax rate of least 15%, i.e. the income inclusion rule [IIR] and the undertaxed payment rule [UTPR]. The subject to tax rule [STTR] is a treaty-based rule that allows source taxation whenever the recipient jurisdiction does not reach a minimum rate of taxation.)

48 For a complete assessment on the proposals that gave give to the Pillar One Proposal, *see* Stefan Greil and Lars Wargowske, "OECD/International- Pillar 1 of the Inclusive Framework's Work Programme: The Effect on the Taxation of the Digital Economy and Reallocation of Taxing Rights", v.73, Bull. Intl. Taxn. 10, IBFD, 2019, <https://research.ibfd.org/#/doc?url=/document/bit_2019_10_o2_2> accessed 28 February 2022.

49 Allison Christians and Tarcisio Diniz Magalhaes, "A New Global Tax Deal for the Digital Age", v. 67:4, Canadian Tax Journal /Revue Fiscale Canadienne, 2019, p. 1153-1159, <https://doi.org/10.32721/ctj.2019.67.4.sym.christians 1153> accessed 03 March 2022. ("The OECD's secretariat subsequently combined elements of the user participation and marketing intangible approaches in a proposed "unified approach" that it released for public consultation in October 2019.)

50 The main difference between these two proposals is that the marketing intangibles proposal views the value created by the market as part of the production sphere as a consequence of the business activities carried out in that market even though remotely while the user participation model understands value as being created in the demand sphere by individuals' consumption.

ternational tax consensus.[51] This is represented by tax treaties that follow the OECD Model and is said to dislocate the place where a business activity is conducted and the place of taxation.[52]

Under the proposals to allocate taxing rights to marketing jurisdictions, "value creation" assumes a different meaning with a broader and positive scope. From a negative allocation rule as formulated by BEPS One, the concept has grown to be a proxy that recognizes the possibility of a virtual nexus combined with a new criterion for profit allocation. This allows source states to tax companies without the need to meet the traditional permanent establishment threshold.[53]

If the value creation standard's negative scope under BEPS One was relatively easy to accept, the same cannot be stated about its expanded connotation under BEPS Two.[54] Unlike being a justification to require economic substance for the allocation of taxing rights, being a proxy to the establishment of a new taxable link entailed heavy criticism over the value creation concept.[55]

Criticism of proposals that attribute taxing rights to market jurisdictions under a value creation justification is not completely unsurprising. A redesign of the global tax base division affects the jurisdictions' interests across the globe in different ways, and any justification provided for a new taxing right would be assessed carefully by all stakeholders. Therefore, the inconsistencies of the value creation standard would no longer be overviewed.[56] The vagueness of the concept was only one of the many problems regarding the positive scope of the value creation standard that prevented consensus about it as the main justification for a new nexus within the BEPS Two work. As a consequence, the expression slowly lost prominence in the papers issued by the OECD.[57]

The most emblematic indication that the value creation concept would not uphold the initiation of a new taxing right derives from the Report on Pillar One Blueprint issued in October 2020.[58] Instead of mentioning value creation, this report justifies a new nexus to expand tax-

51 Jimenez, *supra* n. 05, p. 205.

52 *Idem,* p. 205.

53 Gadžo, *supra* n. 42, p. 97.

54 *See* Christians*, supra* n. 39, p.1383. ("One reason taxing in accordance with value creation has become readily acceptable principle is that the old international tax compromises, designed primarily to prevent double taxation, led the world to a scenario in which double nontaxation became a problem for the governments of high income-nations".)

55 Clair Quentin, "Gently Down the Stream: BEPS, Value Theory and the Allocation of Profitability along Global Value Chains", v.13, World Tax J. 02, IBFD, 2021, p. 163-202, 214, <https://research.ibfd.org/#/doc?url=/document/wtj_2021_02_int_1supra> accessed 20 January, 2022.

56 Ranjan Das, *supra* n. 19, p. 14. ("When the concept [value creation] is extended to act as an underlying principle regarding the allocation of taxing rights, it becomes complicated, moving beyond the confines of a business group into multiple jurisdictions. [...] The lack of consensus on the meaning can also result in chaos if value creation is implemented as rule for taxation, as countries might interpret the concept in a way that expands their tax base.").

57 Wolfgang Schon, "Value Creation, the Benefit Principle and Efficiency- Related Allocation of Taxing Rights" in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 157.

58 OECD, *supra* n. 03.

ing rights in market jurisdictions by reference to an "active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction".[59] Yet, this same paper still refers to the value created by the market jurisdictions to the MNE. While explaining the scope of Amount A, the report states, for instance, that MNE "often exploit powerful customer or user network effects and generate substantial value from interaction with users and customers".[60]

In October 2021, the final version of the Pillar One Proposal was released in a document called the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy.[61] The complex proposal of Pillar One consists of a new taxing right to be created in "market jurisdictions" under the original assumption that value is created therein. This is an attempt to reconcile both the marketing intangibles and user participation proposals. This is to be achieved in broad lines by two means. The first one is by establishing a new nexus that will allow market jurisdictions where goods or services are used or consumed to tax companies even without a physical presence in their territories. The second one is as a profit allocation mechanism named Amount A[62] that built on a portion of deemed residual profits of the taxable companies that constitutes the tax base over which the marketing jurisdiction will tax those companies.[63]

Although the latest OECD documents do not explicitly rely on the value creation expression, Amount A of the OECD's Pillar One proposal was initially based on the idea that the demand side, specifically the market, also adds value to cross border transactions. The rationale behind the value creation standard is still present in the Pillar One proposal, however, it is no longer the main justification for the new tax nexus.[64]

From the aforementioned, it can be deduced that value creation is still relevant under the work of BEPS Two. Nonetheless, value creation's flaws indicate that such a standard might not be sufficient for delivering a new international tax system. The next part assesses those flaws.

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59 *Idem,* p.11. (The entire statement is "Pillar One Blueprint seeks to adapt the international income tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits. Within this context, it expands the taxing rights of market jurisdictions (which, for some business models, are the jurisdictions where the users are located) where there is an active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction.".)

60 OECD, *supra* n. 03, p. 19.

61 OECD, *supra* n. 46.

62 According to Pillar One Proposal, MNEs that fall within the scope for the new nexus will have most of their profits allocated for tax purposes traditionally according to arm's length principle under Amount B whereas 25% of residual profit calculated for an MNE group will be allocated to the market jurisdictions under Amount A.

63 OECD, *supra* n. 46, p.02 ("For in-scope MNEs, 25% of residual profit defined as profit in excess of 10% of revenue will be allocated to market jurisdictions with nexus using a revenue-based allocation key.")

64 Jimenez, *supra* n. 05, p. 206 ("The concept of value creation, as such, does not appear in the most recent documents of the OECD/G20 Inclusive Framework on Pillar 1 (October 2019 and January 2020), but the 'Unified Approach' is the clear recognition that value is also created in the market or the state of location of the customer.")

2. Allocation of taxing rights according to value creation: The same status quo under an incomplete value system

The value creation rationale behind the rules embodied in the OECD's Pillar One along with the Global Anti-Base Erosion proposal (GloBE) rules of Pillar Two [65] are said to have altered the scenario of cross-border taxation so fundamentally that it is possible to discuss the rise of a new international tax system.[66] However, a more comprehensive assessment of the implications of the value creation standard for the allocation of taxing rights as manifested both in the BEPS One's Actions and in the BEPS Two's Pillar One indicates otherwise.

The expression value creation was extensively used in the two phases of the BEPS Project without ever being defined in any of OECD documents. Despite this, a systematic interpretation of the many reports in which it was used can provide some clarification about what "aligning taxation with value creation" means in practical terms. The most likely conclusion derived from this idea is that taxation should happen where the economic activity that generates taxable income takes place.[67] Translating this into international taxation language, the allocation of taxing rights should be the outcome of the following exercise: first, identify which economic activities produce value, then locate them geographically, and finally measure the value generated by each economic activity.

Subsection 2.1 shows that such logic entails an apportionment of multinational taxable income to the same countries that have historically reaped the most benefits from the international tax system. However, it does not reflect other countries' contributions to wealth derived

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65 In broad terms, the Pillar Two Proposal aims to ensure that large MNE groups pay a minimum effective tax rate (ETR) of at least 15% on their profits in every jurisdiction in which they operate. This is to be achieved by allowing countries to impose top-up taxes in situations whenever an MNE is taxed below the minimum rate. *See supra* n. 47.

66 Reuven S. Avi-Yonah, "The new International Tax Regime", U of Michigan Law & Econ Research Paper 21-031, 2021, p. 01-02. <https://ssrn.com/abstract=3939442 or http://dx.doi.org/10.2139/ssrn.3939442.> accessed 28 December 2021. ("On October 8, 2021, 136 countries that formed part of the OECD's Inclusive Forum (IF) to implement the Base Erosion and Profit Shifting (BEPS) project signed a statement (the Statement) that embodies the most far-reaching revolution in international taxation since 1923.1 The Statement marks the beginning of a new international tax regime fit for the 21st century, ITR 2.0.").

67 *See* Werner Haslehner, *supra* n. 31, p.49, (indicating four steps to assess the relationship between value creation and taxing rights in the context of BEPS One: "in order to align taxation with value creation, the OECD (1) declares income as a proxy to value creation (and vice versa), (2) explains value creation as a consequence of the exercise of functions, (3) locates functions in the jurisdiction where sufficient substance can be identified, and then (4) allocates taxing rights over income in line with such substance, closing a circle of proxies where income = value creation = functions = substance".).

from cross-border transactions.[68] Subsection 2.2 points out inconsistencies that oppose value creation as a neutral and sufficient proxy for tax rights allocation.

2.1. Still the old global tax system: Value creation as a status quo keeper

The assumption that aligning taxation with value creation implies performing the aforementioned exercise of identifying what creates value, where it is created, and the amount leads to the following conclusion. The outcome of the value creation standard for global tax allocation depends on how value and its manifestations are understood by the global tax community.

The current global tax discourse endorsed by the work of both BEPS One and Two deems the most value from producing and selling goods and services within a global supply chain comes from intangible assets or inputs.[69] Likewise, within the transfer pricing functional analysis, multinationals' profits should be allocated to jurisdictions where assets are used, risks are assumed, and functions are performed.[70]

Such logic of overvaluing intangibles tends to favor the transfer of most of multinationals' profits to low-tax jurisdictions since intangibles can be easily located through legal means wherever the creator chooses.[71] This flaw was identified by BEPS One for which Actions 8 and 9 specifically intended to curb base erosion and profit shifting practices derived from artificial manipulation of valuable intangibles and risks.[72] BEPS One, however, did not consider the distributional consequences of such value logic.

Valuable inputs associated with intangibles usually occur at the two ends of global chains. They include preproduction (where concept, design, research and development, and licensing are the predominant factors) and postproduction (where branding and advertisement are most relevant) stages.[73] These stages are typically carried out in high-income jurisdictions to which more taxing rights are therefore assigned.[74]

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68 Christians, *supra* n. 39, p. 1383.

69 *Idem,* p. 1381-1382.

70 Solange Screpante, *supra* n. 08, p. 861

71 Gregory Ballentine, "BEPS, Economic Activity, and Value Creation", 105, Tax Notes International, 2022, p.1554.

72 OECD, supra n. 28, p. 09. ("However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.").

73 Quentin, *supra* n. 52, p.170.

74 OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 2013, p.27, http://dx.doi.org/10.1787/9789264192744-en. ("From an economic point of view, most of the value of a good or service is typically created in upstream activities where product design, R&D or production of core components occur, or in the tail-end of downstream activities where marketing or branding occurs. Knowledge-based assets, such as intellectual property, software and organisational skills, have become increasingly important for competitiveness and for economic growth and employment.").

Diversly, intermediate stages of fabrication, assembling, manufacturing, and resource extraction are deemed to add low value to the chain.[75] These stages are typically located in low-income countries where firms make extra profits by exploiting underpaying labor, natural resources, and lack of proper regulations. Nevertheless, these activities are not often regarded as high value creators under the prevailing value-creation paradigm.

As an outcome, poor jurisdictions are allocated a much smaller portion of the global tax base in comparison to jurisdictions that provide intangibles assets which are usually those that are high-income. In adopting such a narrow view on value, current discussions at the international level have not recognized the valuable contributions associated with the use of human and natural resources in low-income jurisdictions.

Not even the new nexus that allocates taxing rights to market jurisdictions under the Pillar One proposal of BEPS Two is able to move the largest share of the global tax base out of high-income jurisdictions. According to the Pillar One plan, Amount A will only be assigned to market jurisdictions for multinational groups that fall within the scope of the new nexus, whereas Amount B will accord with the traditional arm's length approach.[76] Most of the global tax base will not be affected considering that Amount A is only 25% of a multinational group's residual profit (defined as profit in excess of 10% of global revenues).

In this sense, Pillar One maintains that the most value is created through intangibles but adds that the consumer market also creates value that needs to be duly considered for the allocation of taxing rights. Yet, the world's largest markets are located in developed and high-income countries thus it is reasonable to assume that they will benefit the most from Pillar One's Amount A.[77]

The value creation standard serves as a persuasive rhetorical argument to push for important reforms. Its application potentially modernizes the international tax system by dealing with base erosion and profit shifting practices enhanced by the digitalization of the economy. Even though later relinquished as its main justification, the value creation standard also brought about the creation of a new nexus that dismisses physical presence to allow source taxation and better reflects the current business reality.

Yet, the value creation standard cannot presumably create a truly new international tax system as it is not thorough enough to encompass all values' different expressions in international cross border transactions. Additionally, the allocation outcome it entails favors the same jurisdictions that have always benefited the most under the "old" system.

75 Quentin, *supra* n. 55, p.170.

76 OECD *supra* n. 31.

77 Christians and Diniz Magalhaes, *supra* n. 49, p. 1159.

2.2. Lack of a sufficient theory and an incomplete system

Value creation as a logic to drive tax allocation has inconsistencies that lead to the result of its application being unsatisfactory as demonstrated in the previous section. Part of these inconsistencies stem from the very origin of the value creation standard as applied to taxation that can be traced to managerial and business science theories.[78] The other types of inconsistencies derive from the very meaning of value and its association with taxation.

The idea according to which taxing rights should be assigned to the place where the activities giving rise to taxable income takes place is grounded on the analysis of business' value chains performed as part of strategic management.[79] Such an analysis is a business and managerial tool for ascertaining which parts of the overall business contributes with which amount to the general business value and competitive advantage. It begins by disaggregating a firm into its main functions and subsequently assessing the inputs and outcomes of each of them. The primary goal of this analysis is to help stakeholders identify what parts of the organization carries the real value drivers within a firm in order to make more efficient business decisions.[80]

Putting the technique of value chain analysis into a transfer pricing context clarifies its connection with the allocation of taxing rights. Identifying value drivers within a supply chain helps guide the allocation of income within the multinational group and, accordingly, the distribution of taxing rights. In fact, a value chain analysis is an essential part of transfer pricing's functional analysis. It aims to identify exactly how functions, risks, and assets are combined within a multinational enterprise to assess the arm's-length remuneration for each transaction.[81]

The relevance of a value chain analysis as a tool in the rather complex process of establishing arm's-length prices might explain the appeal of value creation as a standard for tax purposes.[82] However, it is not capable of providing a normative justification for the resulting allocation.[83] The value chain analysis' concept of value is purely managerial and not quantitative. It was not created to determine the quantifiable contributions to profitability made by each area of a firm's activities.[84] A managerial business technique to trace value drivers within a private business that

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78 Referring to the origin of value creation concept and its use in international taxation, *see* Ranjan Das, *supra* n. 18, p. 135-136.

79 The business economics literature defines value chains as the basic tool for examining all activities that a firm performs and how they interact with the purpose of analysing the sources of a firm's competitive advantage. *See* Michael E. Porter, "Value Chain and the Competitive Advantage", in David Barnes (ed), *Understanding Business: Processes*, Routledge, 2001, p. 50.

80 Schon, *supra* n. 57, p. 159.

81 Screpante, *supra* n. 08, p. 864.

82 Emmanuel Linares and Ralph Meghames. "Value Chain Analysis: An Analytical Tool to Evaluate Economic Contribution in the Overall Framework of Value Creation", in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 186.

83 On the importance of normative discussions of the theories that justify tax allocation, *see* Ivan Ozai, "Origin and Differentiation in International Income Allocation", 44:1 Dalhousie Law Journal 2021.

84 Quentin, *supra* n. 55, p. 205.

is not necessarily international nor organized into different legal units bears no logical relation to international taxation.[85] Therefore, reconciling the elements of that internal business technique to the allocation of taxing rights among sovereign jurisdictions cannot possibly entail a coherent outcome without any adaptation.

The other type of inconsistencies that the value creation standard bears is directly linked to the very concept of value and its relation to corporate taxation. Although economists have long attempted to explain the meaning and origins of value, economic theory has not been able to offer a final answer.[86] Value theories can be broadly classified into classic theories and neoclassic theories or marginalists by somewhat reflecting the historic period in which they were created.[87] Classic value theories (also called objective theories) consider that value derives from the costs of production, especially labour. Therefore, the activity subsequent to this does not create inherently value.[88] Neoclassic value theories (also known as marginalists or subjective theories) are based on concepts of utility and scarcity according to which the value of things is measured by their usefulness to consumers. Price is the main measure of value for marginalists value theories,.[89]

At the same time that there is not only one concept of value nor a unique definition of what it emerges from, the link between value creation and corporate taxation is rather questionable. The latter is taxation on capital income or profits. However, value is not the equivalent to income or profit in the same way that “value creation” is not equivalent to “income or profit generation”. The best possible approximation between income and value is done by using the neoclassical economic concepts of “value in use” and “value in exchange”.[90]

Capital income can be deemed to be money earned or received or revenue after expenses in a very broad and intuitive perception.[91]

Value in use refers to “specific qualities of the product perceived by customers in relation to their needs”[92] or the total utility a good provides to the consumer. It embodies a subjective idea because it represents the value of a product or service before market transactions. Value in

85 Quentin, *idem.*

86 Each of the value theories proposed by different economists throughout time have many differences, and the classification used is not very precise. *See* Wolfgang Grassl, Toward a Unified Theory of Value: From Austrian Economics to Austrian Philosophy. *Axiomathes* 27, 531–559 (2017), <https://doi.org/10.1007/s10516-017-9348-0> accessed 10 January 2022.

87 *See* Robert B. Ekelund Jr. and Robert F. Hebert, *A History of Economy And Method*, 6th ed., Waveland Press, 2014, p. 394 and p. 545.

88 Mariana Mazzucato. *The Value of Everything: Making and Taking in the Global Economy*, Penguin Books, 2019, p. 45.

89 *Idem,* p. 65.

90 On the generation of income by references of value in use and value in exchange, *see* Werner Haslehner, *supra* n. 31, p. 43.

91 Business income in tax law literature is broadly referred to as profit, and profits from different origins are referred to as being kinds of business income. *See* Brian J. Arnold, *International Tax Primer,* 3rd ed., Wolters Kluwer, 1996, p. 154. (“The OECD and UN Model Treaties distinguish between several types of business income. For example, profits from immovable property, profits from international shipping and air transportation, and profits from entertainment and athletes’ activities are dealt with Articles 6, 8, and 17, respectively.”)

92 Cliff Bowman and Veronique Ambrosini, “Value Creation Versus Value Capture: Towards a Coherent Definition of Value in Strategy”, v.11, n. British Journal of Management, 2000, p.01- 03, <https://onlinelibrary.wiley.com/doi/full/10.1111/1467-8551.00147> accessed 7 December 2021.

exchange refers to trade value as the amount of value realized when an exchange takes place[93] which usually does not coincide with the value in use.[94] Value in exchange is represented by prices and, as such, it is influenced by supply and demand.[95] Every time the price or the exchange value that a company receives for a product or a service exceeds the exchange value it paid for its inputs, economists talk about capture of value.

Comparing the concepts mentioned previously, income for tax purposes is better identified with capture of exchange value.[96] Nevertheless, the value creation theory that underlies the OECD's work seems to be based on a managerial business theory. It evokes value in a sense closer to value in use, that is, value "created" by economic production within the firm but before market exchanges.

The value created does not seem to be the most appropriate proxy for taxation over income even disregarding the economic nuances of the meaning of value. The concept could be more suitable to consumption-based value-added taxes given that this form of taxation is levied on the output of a certain transaction within a supply chain irrespective of profits or losses.[97]

In addition to this conceptual inconsistency between value and capital income that makes the link with corporate taxation tenuous, there are practical issues associated with each of the elements that need to be identified in order to "align taxation with value creation". To state that income taxation is to be levied where the economic activities giving rise to value take place implies that the income to be taxed derives from an economic activity that can be geographically located. However, profitability or taxable income can arise from many different factors that cannot easily be deemed to stem from a specific economic activity or be located within a firm's value chain. Profitability often derives from the exploitation of specific conditions of the place where the economic activity is performed, from specific market powers like monopoly power, or to the mere fact that multinational enterprises benefit from group synergies just for being part of a group.[98]

Moreover, income does not necessarily accrue to who creates value but might flow to someone else in the economic chain.[99] There is no necessary coincidence between where or what

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93 *Idem,* p. 3.

94 In monetary terms, the value in use is the amount that the consumer would be willing to pay for the good or service whereas the value in exchange is the amount he actually pays which is usually less. The difference between what the use value and the exchange value is called by economists as *consumer surplus*. When these values equate, the price is called *total monetary value*.

95 Joseph E. Stiglitz, *Principles of Microeconomics*, 2nd ed., Stanford University, 1997, p. 91.

96 Haslehner and Lamensch, *supra* n. 27, p. 5 ("income corresponds to value capture more than value creation").

97 Marie Lamensch, "Value creation and VAT", in Werner Haslehner and Marie Lamensch (eds), *Taxation and Value Creation,* Volume 9, IBFD, 2020, p. 80.

98 Location specific savings and group synergies are examples of some of the most controversial issues concerning the application of arm's length principle, both referred to in the 2017 OECD Transfer Pricing Guidelines.

99 Haslehner, *supra* n. 31 , p. 44.

– which economic activity performed in which jurisdiction – creates value and where or what – which enterprise located in which jurisdiction – captures the value and accrues the income.[100]

All of these inconsistencies reveal that the idea of aligning taxation with value creation is not a coherent theory that is understood as a logically connected system of general premises applied to a specific area of knowledge.[101] Not even the very fundamental concepts of value and value creation have been defined under a minimally systemized set of propositions. Rather, these concepts have been imported from non-normative theories, oversimplified, and deployed in different ways to underpin very diverse tax designs in a clear lack of a unified meaning and internal coherence. Without an underlying theorization, the idea of aligning taxation with value creation leads to a broad and empty standard. Its content can be filled according to what determines the dominant tax policy and prevailing global interesses and cannot yield a truly new international tax system.[102]

This is not to argue against the adoption of a value standard for tax purposes but to call for a more sophisticated and comprehensive theorization of value that encompasses diverse value manifestations. To develop such a theory, it is necessary to find a more comprehensive understanding of value by addressing the theories that inspired the use of the value creation standard in international taxation. The first lines of such a theory are the subject of the following section.

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100 *See* Hey, *supra* n. 06, p. 203 (“The lack of a clear concept already reveals itself in the combination of “(real) economic activity” and the “creation of value”. In this context, the OECD refers to both at the same time, even though the location of the real economic activity and that of the creation of value do not necessarily coincide.”).

101 Gabriel Abend, “The Meaning of ‘Theory.’”, Sociological Theory. v. 26, n.02, 2008, <doi:10.1111/j.1467-9558.2008.00324.x> accessed 08 March 2022.

102 *See* Jiménez, supra n. 05, p. 198. (“How can such a vague and open-ended principle [value creation] have any significance at the level of tax policy formulation or treaty interpretation if it can be used to defend any position?”).

3. Towards a comprehensive value theory for a new international tax system

For a theory of value to entail a genuine new international tax system, it must be comprehensive, meaning that it has to account for all processes of wealth generation and distribution made possible by cooperation among countries. To achieve this goal, a value theory for tax purposes should encompass not only the notion of value creation but also the equally relevant concept of value extraction assuming that both are part of the same phenomenon, i.e. value capture. Both value capture and value extraction were briefly mentioned in subsection 2.2 and will be further explained in this section.

Inasmuch as the value creation notion itself, value capture and value extraction are concepts collected from managerial business and economic sciences. Integrating them into a value theory for tax purposes and assessing their interactions with the prevailing notion of value creation would entail a system that is more consistent with the sciences from which they were imported. Such a theory would consequently allow for a better allocation of taxing rights among countries according to their different contributions by deploying a more internally coherent and comprehensive view of value.

3.1. Two missing concepts: Value capture and value extraction

It is necessary to frame the proposed value theory and establish its premises before introducing the concepts of value extraction and value capture.

A comprehensive value theory for tax purposes is actually an expansion of the value creation theory and not a complete deviation from it. It aims to be compatible with tax principles as an improvement upon the current system that is based on the idea of tracking value. Such a comprehensive theorization of value realizes that a complete and more detailed notion of value must be taken into account bearing in mind extraction and capture and not just creation if considering value for tax purposes. The claim for a broader notion of value stems from the understanding that both the strategic management science and economic sciences

referred to in subtopic 2.2 and from which the value notion applied to taxation derive have a wider understanding of value.[103]

Placing the proposed theory among those of economic value, a comprehensive value theory would consider value under a marginalist or neoclassic approach. In this sense, it deems the value to be subjective based on the notions of utility and scarcity and broadly identified with price. By embracing the subjective character of value, the prosed theory admits that it is not possible to find a completely objective or even purely scientific and, therefore, neutral way to allocate profits among jurisdictions on a value basis.[104] Finally, the "value" referred to is what is referred to as the value in exchange, i.e. the trade value, considering the aim of driving income for tax allocation purposes.

Defining the concepts, value creation refers to any ways in which different types of resources – human, physical, and intangibles – interact to produce new goods and services.[105] Anything and anybody that creates value in this context is a wealth creator.[106]

Value extraction, on the other hand, concerns activities that move around existing resources and outputs and benefits from those resources[107] without the corresponding contribution for its creation.[108] It means basically benefitting from the value created by something or someone else by generating income without producing anything new. Value extraction usually happens by charging above the competitive price, undercutting competition, exploiting particular advantages, and using monopoly power.[109]

Beside these two concepts, there is value capture.[110] It is the process of retaining a percentage of the value exchanged in a transaction represented by the price. It is the realization of the

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103 *See* Mazzucato, *supra* n. 88, p. 19. (Mariana Mazzucato explains that economic sciences have historically divided activities according to whether they produce value, whether they are productive, and refers to this division as the production boundary. She states that the wealth creators are inside the boundary whereas the "beneficiaries of that wealth, who benefit either because they can extract it through rent-seeking activities, as in the case of a monopoly, or because wealth created in the productive area is redistributed to them" are outside.) For references of value extraction and value capture in managerial science, *see also* Bowman and Ambrosini, *supra* n. 92.

104 *See* Christians, *supra* n. 39, p. 1380. ("It is incontrovertibly wrong to think that a dollar of income that depends on a seamless symbiotic global economic order can somehow be re-fragmented and correctly assigned to one or another jurisdiction as technical or economic matter.").

105 Mazzucato, *supra* n. 88, p. 06.

106 *See* Manfred Hoefle, "Value Extraction or Value Creation: Two Opposing Economic Practices", Manegerism, Think Piece n. 11, <www.managerism.org/topics/value-creation/thinkpiece-no-11> accessed January, 24, 2022. (Defining a value creating economy as one where "goods are manufactured and useful services are rendered. In contrast, the finance sector should be a relative small branch that serves the real economy").

107 Mazzucato, *supra* n. 88, p. 06.

108 Value capture through value extraction can be broadly identified with true economic rents. *See* Joseph Bankman, Mitchell Kane and Alan Sykes, "Collecting the Rent: The Global Battle to Capture MNE Profits", 72 Tax Law Review 2018, 197 [is this the page where they say that? Better to include a quote].

109 *See* Hoefle, *supra* n. 106 (stating that "value extraction exists when certain groups obtain an unfair advantage in a market" and that value extractors are "not only marginally active (or rather inactive) in creating genuine economic value, they also grab an excessively large piece of the economic cake for themselves"). Examples provided by the author include economic rent-seeking by monopolization of markets, locking-in of customers, and denial of co-accountability for social wellbeing.

110 Although agreeing that profitability does not reflect value creation, David (Clair) Quentin and Liam Campling seem to identify "value capture" with what is referred to in this text as "value extraction". *See* David Quentin and Liam Campling, "Global Inequality Chains: Integrating Mechanisms of Value Distribution into Analyses of Global Production", v.18, n.01, Global Networks, 2018, p.33-52 <https://onlinelibrary.wiley.com/doi/full/10.1111/glob.12172> accessed 23 March, 2022.("For those more familiar with the tax system, the key message is that profitability within multinational enterprises may reflect surplus extraction rather than wealth creation, value capture rather than value creation.").

difference between what a company receives from the consumer for a good or a service and what it pays for all its inputs. Value captured is therefore the amount retained in the realization of the exchange value of a product or service when the exchange value, or price, exceeds the value of the inputs.[111]

Therefore, the value that a company captures in a transaction could theoretically derive from value creation or value extraction.[112] However, the current value theory that informs international tax discussions considers only value creation as a proxy for sharing profits among multinational enterprises.[113]

A better illustration of what those concepts mean for international taxation and how their assimilation would be able to improve the tax allocation system is provided by an assessment of the scenario described in subsection 2.1 regarding how value is recognized in global value chains for tax purposes. The current value creation standard adheres to the Acer´s "smiling curve" [114] deeming that most value within a supply chain is created at its two ends whereas not much value is created in the intermediate stages. However, disregarding the amount of value deemed to be created in each stage of the chain and the taxes therefore collected in each jurisdiction, multinational enterprises capture value in the form of corporate profits all throughout their supply chain. Actually, most of the value captured by multinational enterprises actually derives from value extraction rather than value creation in the less financially advantaged jurisdictions where less value is deemed to be created. In those countries, multinationals generate extra income that is booked somewhere else in the world by taking local natural and human resources to which they did not contribute value without the proper compensation.[115]

On value terms, there is value extraction whenever a multinational enterprise captures value in a cross-border transaction but no proportionate value is deemed to be locally created for tax purposes. Wherever a company captures value by means of value extraction, it leaves the exploited country less financially advantaged in comparison with its trading partners from which value is captured by means of value creation. In tax terms, the jurisdiction providing the undetected value is deprived of the corresponding tax revenue whenever a multinational

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111 In a definition that is aligned both with a marginalist approach of value and with the identification between value in exchange and price, Bowman and Ambrosini argue that "that although value is created by organizational members, value capture is determined by the perceived power relationships between economic actors." *See* Bowman and Ambrosini, *supra* n. 92, p.01.

112 For a brief though interesting assessment of the interaction between capture, extraction and creation of value, *see* Werner Haslehner and Marie Lamensch, *supra* n. 27, p. 06-07.

113 *See* Quentin, *supra* n. 55, p. 213 (arguing that the "problem that the BEPS process had been running up against is a simple contradiction. On one limb of the contradiction, there is the fact that the taxation of corporate profits involves the taxation of both value creation and value capture, and so there is nothing in the principles of the tax that enable a distinction between the two.").

114 The Acer Curve, also referred to as Smile Curve, is a concept first proposed by Stan Shih, the founder a technology company called Acer Inc. Currently, the idea is used by business managerial theory to explain how value added varies across the different stages of development, production, manufacturing, and selling technology related products. For an analysis of the Acer Curve and its interaction with tax law, *see* Quentin and Campling, *supra* n. 110.

115 *Idem.*

enterprise captures value in a cross-border transaction but no proportionate value is deemed to be locally created for tax purposes.

This scenario creates a double benefit for companies. They profit from value to which creation they did not entirely contribute while ensuring that private profits go undertaxed in that jurisdiction. For the exploited country, there is instead a double disadvantage, i.e. value is withdrawn from its territory at the same time that it is deprived of the corresponding revenue stream.

The described scenario happens because the current approach disregards that the value a company captures might derive either from value creation or value extraction. Moreover, the current value logic oversees that value capture does not necessarily happen where value creation and value extraction take place. They might even happen out of the boundaries of the enterprise that captures value.[116]

3.2. Taxation according to value capture

From what has been indicated thus far, value captured and not value created is a proxy for profitability because it equals income deriving from the realization of exchange value. Value capture is therefore more suitable as a base for tax allocation over income.

The incorporation of the value capture notion strengthens the link between value and income thereby eliminating one of the main inconsistencies of the value creation standard, i.e. the fragile link between income and value created. Assuming that value capture as a proxy for profitability is a better driver for the allocation of taxing rights, however, does not inherently constitute the value creation standard. This is because the original problem remains of how to allocate taxing rights according to profitability. Actually, recognizing value capture as a proxy to drive the allocation of taxing rights lies in understanding that it also stems from value extraction and not exclusively from value creation. Thus, aligning taxation with value capture means that taxation should happen where both the value is created and where it is extracted.

There are two primary approaches for taking value extraction into account when considering value for tax purposes. The first is to be adopted whenever there is a corporate footprint in the jurisdiction from where value is extracted via a legal entity. Under this scope, the value capture theory is limited to the allocation of taxing rights within a transfer pricing context. In it, the taxation according to value capture is to be done by taking value extraction into account when assigning income across the members of a multinational group. The goal is to ensure that the

116 David Quentin, “Corporate Tax Reform and “Value Creation”: Towards Unfettered Diagonal Re-allocation Across the Global Inequality Chain”, v.07, Accounting, Economics, and Law: A Convivium, 2017, p.01-06, <https://www.degruyter.com/document/doi/10.1515/ael-2016-0020/html> accessed 10 March, 2022. (“It would follow that a corporate tax base which is truly aligned for tax purposes with “value creation” or “economic substance” might find itself in a different jurisdiction from any of the jurisdictions in which the group realizing the profits has any kind of corporate footprint”.).

profits deriving from such an extraction entail local taxation accordingly. Such value extracted should be converted into transfer pricing terms. A feasible method is through location savings.[117]

Location savings are costs savings attributable to specific location features for which the exploitation entails incremental profits that are deemed to be specific and exceptional value drivers in a transfer pricing analysis.[118] Countries that provide such savings with specific features of their location are entitled to a greater share of tax revenues since those savings entail an increment in the enterprise's profit. Location savings are a suitable tool to account for the value extracted from jurisdictions and captured by enterprises. This is because human and natural value extracted from a jurisdiction in the form of underpaid labor, uncompensated environmental impact, and extraction of natural resources are costs saved for the enterprise that exploits such conditions and converts them into extra profits or more value captured.[119]

A comprehensive value theory could also function as an interpretation guidance for the entire international tax system because not all of the value captured by a company stems from jurisdictions where the company has a tax presence. That said, the second possible approach derives from the understanding that value extraction should entail the adoption of unilateral compensating measures by the jurisdictions from which value is extracted by allowing the expansion of their internal tax base. In this context, it is a justification for internal and unilateral tax measures adopted by different jurisdictions aiming to be compensated from value extracted therein whenever transfer pricing rules do not take place.

The expansion of these jurisdictions' internal tax base could be achieved through a range of diverse measures that have the potential to redefine the way the international tax base is shared among jurisdictions[120]. In any case, in order to be efficient, such measures should be recognized by the international tax system and not be undermined by tax treaties provisions.

Unilateral tax measures over income deriving from cross-border transactions are more easily applied when there is a tax nexus either under current or forthcoming ones. In the presence of a company's permanent establishment that is capturing value by means of extraction in the jurisdiction where the value is being extracted, what is known as resource rent taxes are an

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117 Location savings along with market premiums are referred to as types of location specific advantages. Location specific advantages are location specific features that are deemed to be value drivers in a transfer pricing analysis. *See* Jinyan Li and Stephen Ji "Location Specific Advantages: A Rising Disruptive Factor in Transfer Pricing", v. 71, Bull. Intl. Taxn. 05, IBFD, 2017.

118 *See* UN, *Practical Manual on Transfer Pricing for Developing Countries*, United Nations, 2017. (The UN Manual defines location savings as "net cost savings that a multinational enterprise realizes as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction").

119 There are a few possible ways to convert these costs saved into transfer pricing terms in order to assign the exploited jurisdiction with the associated tax revenue. For an elaboration, *see* also Allison Christians, "Designing a More Sustainable Global Tax System", v.44, Dalhousie LJ, 2021. *See* also Li and Ji, *supra* n. 177.

120 For an extensive description of unilateral measures that could be taken by countries to capture cooperative surplus, *see* Allison Christians and Tarcísio Diniz Magalhães, "The Rise of Cooperative Surplus Taxation", SSRN, 2020, < https://ssrn.com/abstract=3687011> accessed 12 March 2022.

example of a suitable measure. They are profit-based taxes imposed on economic rent as a form of excess profits taxation but specifically used to compensate resource-rich countries for the removal of non-renewable sources of wealth such as oil, gas, or hard minerals from their territory.[121] The extraction of natural resources that are finite and usually scarce are a source of value capture for companies. Taxes directly connected to the value extracted in the source jurisdiction by means of withholding payments made to the company are a relatively simple way to compensate such value extraction.

Finally, in the absence of a tax nexus, the enhance in the internal tax base of the country from where value is extracted could be done through taxation imposed on any revenue flow to the non-resident entity. In these cases, payments from the jurisdiction from which value is being extracted to the nonresident entity could also be taxed through withholding taxes.

The measures mentioned previously are only examples of the type of change that a comprehensive perception of a value theory could entail for the allocation of the international tax base.

121 *Idem,* p.17.

Conclusion

An assessment of the genuine issues at stake under the current value theory framework and the consequences of its application for global allocation of taxing rights necessitates its improvement. The value creation standard lacks coherence as theory and does not deliver an allocation of taxing rights that truly reflects countries' real contributions for the wealth created by cross-border transactions.

To properly reflect the inputs that different jurisdictions provide for global wealth production, international tax rules need to embrace a comprehensive notion of value. It will be based on value capture which includes the notion of extraction along with the idea of creation to build a value theory for tax purposes.

A comprehensive value theory that recognizes that value capture derives not only from value creation but also from value extraction and allocates taxing rights accordingly can potentially yield a new international tax system. Otherwise, in continuing to adopt the current narrow and incomplete view of value, global tax norms will continue enhancing tax collection for the big value capturers. This will deprive those from which value is extracted from the tax revenues in relation to their contributions to the global economy. The old international tax system will remain.

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Value creation, value capture, and value extraction:
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