Editors: Werner Haslehner and Marie Lamensch

TAXATION AND VALUE CREATION

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Taxation and Value Creation

Why this book?
The suggestion to "align international taxation with value creation" first emerged in the context of the OECD BEPS Project aimed at tackling aggressive tax planning strategies resulting in base erosion and profit shifting. The concept of "value creation" was then further relied on in the broader discussion that followed about the impact of digitalization on the global economy generally and the fair allocation of taxes between countries in this new environment. Although the idea – or the guiding principle – that profits should be taxed where economic activities occur and where value is expected to be created initially received a relatively large support, it rapidly became clear (at least to academics) that there would be no obvious answer to the question "where is value being created?" in a manner that would be relevant for (international) tax purposes, inter alia in view of the different models of value creation within corporate entities.

Based on 9 thematic reports (offering an interdisciplinary discussion of the concept of value creation mostly from an international perspective) and on 23 national reports (focusing on the meaning of value creation in domestic tax law), this book seeks to contribute to the discussion on whether the concept of value creation is viable, both theoretically and in practice, as a criterion for the allocation of taxing rights under a modernized international tax framework.

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Preface

This volume contains the results of a research project on the meaning and relevance of "value creation" in taxation conducted on behalf of the EATLP in the academic year 2019-2020.

The project itself and this book is divided in two interrelated parts. The first part consists of an analysis of the possible meaning of value creation from a primarily international and interdisciplinary perspective, which is conducted in nine self-standing thematic reports that zoom into "value creation" as a conceptual framework, that explore its meaning under the "value added" tax system and its relevance from an economic and transfer pricing perspective. The thematic reports also analyse the reliance on the concept in the OECD-led (and other) reform efforts for the international tax system, its compatibility with the idea of inter-nation equity, and go into practical examples of value chain analysis and exit tax rules that help understand the concept's usefulness and importance.

The second part consists of 23 national reports completed in response to a questionnaire prepared by the general reporters with the aim to identify the commonalities and differences in the approaches of participating countries as regards the meaning and relevance of value creation in national income tax laws. The general reporters expected rather little direct evidence for the relevance of "value creation" as a key feature of national income tax laws, yet sought indirectly to explore possible connections. The confirmation that there does not appear to be a common understanding of "value creation" across national legal tax systems is, in the authors' views, already in itself an important finding of the research project.

The editors gratefully acknowledge the contributions of all the authors of the national and thematic reports without whom it would have been impossible to write a general report and bring the entire project to fruition, and to Thomas Chaperot for his support in organizing the communication with the national reporters. They also wish to thank Daniel Gutmann who, in his capacity of Academic Chairman of the EATLP, was strongly involved in the shaping of the entire project from the creation of the questionnaire to the identification of topics and the choice of thematic reporters, and, together with Adolfo Martín Jiménez, also provided robust feedback to the general reporters on their conclusions. Additional thanks to Enguerrand Marique, who, in addition to being an invaluable help in organizing the collection and hard editing of contributions, also acted as a sounding board and discussant

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Table of Contents

Preface v

About the Authors vii

Part One
General Report

Chapter 1: General Report on Value Creation and Taxation: Outlining the Debate 3
Werner Haslehner and Marie Lamensch

1.1. Introduction 3

1.2. The meaning of "value" and "value creation" 4
1.2.1. Theories of value and value creation 4
1.2.2. Value creation and income taxation: A tenuous link 5
1.2.3. Value creation and VAT: Is there a link? 10

1.3. Value creation and international tax reform 12
1.3.1. The reasons and options for reform 12
1.3.2. Value creation and the OECD Model 13
1.3.3. Aligning taxation and value creation in BEPS 1.0 14
1.3.4. BEPS 2.0: Going beyond transfer pricing – And value creation? 17
1.3.5. The impact of international tax reform on inter-nation equity 21

1.4. The meaning and role of "value creation" in national income tax law 23
1.4.1. The relevant meaning of "value" in national tax laws 24
1.4.2. Value creating assets and their valuation 25
1.4.3. The relevance of "changes in value" in national tax laws 26
1.4.4. Value creation and attribution of income 27
1.4.5. The relevance of value-creating activity for taxation 29
1.4.6. Taxing value creation in non-market transactions 30
1.4.7. The importance of localized value creation source rules 30

1.4.8. Aligning domestic transfer pricing approaches to the OECD guidance on “value creation” 32
1.4.9. Changes in national tax law to tackle digitalization challenges 33

1.5. Conclusion 35

Part Two
Thematic Reports

Chapter 2: Value Creation and Income Taxation: A Coherent Framework for Reform? 39
Werner Haslehner

2.1. Introduction 39

2.2. The meaning of “value creation”: A cross-disciplinary perspective 41
2.2.1. The (lack of) meaning of value and the (tenuous) link between value creation and income 42
2.2.2. Allocation of taxing rights over income: A production-based paradigm 44

2.3. An International Tax Reform based on (a coherent concept of) value creation? 49
2.3.1. Post-BEPS transfer pricing as an alignment of taxation with value creation 50
2.3.2. Allocating income beyond the arm’s length standard 54
2.3.3. Further questions on the use of “value creation” as a basis for allocating taxing rights 58

2.4. Conclusion 60

Chapter 3: Value Creation and VAT 63
Marie Lamensch

3.1. Scope and objective of this report 63

3.2. Key features of the value added tax system 63
3.2.1. A broad based, multi-stage but non-cumulative consumption tax 63

3.2.2. Transnational/cross-border application of the tax 66
3.2.2.1. Tax levied "at destination" 67
3.2.2.2. "Fixed establishment" for VAT purposes vs "permanent establishment" for CIT purposes 68

3.3. Valuation rules (EU) 69
3.3.1. General rules 69
3.3.2. Special rules 73
3.3.2.1. Imports 73
3.3.2.2. Transactions between related parties 74
3.3.2.3. Internal and deemed supplies 79
3.3.2.4. Special schemes 79

3.4. Value creation and VAT: Is there a link? 80
3.4.1. The meaning of "value" under the "value added tax" system 80
3.4.2. Is VAT levied upon "value addition" in the production process? 81
3.4.3. Is there a link between "value addition" and "value creation" and what is the consequence of a "reduction" of value? 82

3.5. "Value addition", "value creation" and allocation and enforcement of taxing rights 83
3.5.1. Inter-nation equity 84
3.5.2. Enforcement on non-resident taxpayers and increased compliance burden 86

3.6. Conclusion 88

Chapter 4: Taxation in the Place of Value Creation: An Economic Perspective 89
Clemens Fuest

4.1. Introduction: Corporate taxation and idea of taxation in the place of value creation 89

4.2. The role of the corporate income tax in the overall tax system 90

4.3. What does "taxation in the place of value creation" mean and how could it be implemented? 92

4.4. Existing international tax rules: Does the location of value creation play a role? 96

4.5. Why do the existing rules need to be reformed? 97

4.6. Would more taxation where value is created improve economic efficiency or fairness of the international tax system? 98
4.6.1. Fairness in the international distribution of taxing rights 98
4.6.2. Economic efficiency and tax distortions 99

4.7. Do the current OECD reform proposals follow the principle of aligning taxation with value creation? 100

4.8. Conclusions 103

Chapter 5: Value Creation and Transfer Pricing 107
Jérôme Monsenego

5.1. Introduction 107

5.2. Brief historical overview 108

5.3. The 2017 update to the OECD transfer pricing guidelines with respect to the objective of aligning transfer pricing outcomes with value creation 114

5.4. Comparative overview 125

5.5. The concept of value creation in the “Pillar One” project 126

5.6. Conclusion 128

Chapter 6: The Value Creation Mythology 131
Richard Collier

6.1. Introduction 131

6.2. What does the term value creation actually mean or refer to? 133

6.3.	Does the notion of value creation have a firm basis as a principle in the international tax system?	138
6.4.	Is it helpful to posit value creation as a paradigm or principle for interpreting or applying the ALP?	143
6.5.	Value creation as a paradigm of the existing ALP system	145
6.6.	Value creation as a normative standard	149
6.7.	Conclusion	154
Chapter 7:	**Value Creation, the Benefit Principle and Efficiency-Related Allocation of Taxing Rights** *Wolfgang Schön*	155
7.1.	Value creation – Its rise and fall in international tax policy	155
7.2.	Benefit principle and value creation	158
7.3.	Value creation and market countries	161
7.4.	Benefit principle, tax competition and economic efficiency	163
7.5.	Economic efficiency, markets and rents	165
7.6.	Efficient taxation of the digital(ized) economy	167
7.7.	Conclusion	168
Chapter 8:	**Value Creation and Inter-Nation Equity** *Irene J.J. Burgers*	171
8.1.	Introduction	171
8.2.	Can a value creation based allocation be justified with the idea of inter-nation equity?	171
8.2.1.	Richard and Peggy Musgrave’s inter-nation equity: Four justifications for source taxation	171

8.2.2. Other scholars: The international tax system can be used for achieving human rights 174
8.2.3. Value creation based allocation can be justified with the idea of inter-nation equity 176
8.2.3.1. Inter-nation equity built on economic ideas of fairness 177
8.2.3.1.1. Origin 177
8.2.3.1.2. Location of investment 177
8.2.3.1.3. Benefit, origin and economic rent 178
8.2.3.1.4. Economic rent 180
8.2.3.2. Inter-nation equity built on political ideas of fairness 180

8.3. Would a change of attribution to attribution on the basis of a standard of "value creation" result in a fairer distribution of taxing rights at the global level? 181

8.4. Conclusion 183

Chapter 9: Value Chain Analysis: An Analytical Tool to Evaluate Economic Contribution in the Overall Framework of Value Creation 185
Emmanuel Llinares and Ralph Meghames

9.1. Introduction 185

9.2. The purpose of a value chain analysis 186

9.3. Value chain analysis – Proposed framework for application 188
9.3.1. Value chain concept 188
9.3.2. Value chain analysis: A proposed analytical framework for transfer pricing 189
9.3.2.1. Step 1. Analysing value drivers 190
9.3.2.2. Step 2. Linking the enterprise's functions, risks and (intangible) assets with value drivers 191
9.3.2.3. Step 3. Mapping roles, responsibilities and control of the individual group entities 191
9.3.2.4. Step 4. Assessing bargaining positions in the internal pricing process 194

9.4. What are the next steps to a value chain analysis? 195
9.4.1. From value chain analysis to pricing transactions and profit allocation 195
9.4.2. Uses and misuses of value chain analyses 196

9.5. Conclusion 197

Chapter 10: Value Creation and Exit Taxes 199
Claus Staringer

10.1. Introduction 199

10.2. Valuation for exit taxes – An issue primarily under domestic law 201

10.3. International coordination of exit tax valuation 202
10.3.1. The case for bilateral coordination 202
10.3.2. Valuation coordinated by tax treaty 202
10.3.3. The weakness of a coordination rule 203

10.4. Coordination by methodology – The use of OECD transfer pricing principles for exit taxation 204
10.4.1. The OECD arm's length principle as an internationally accepted valuation framework 204
10.4.2. The Austrian example 205
10.4.3. Practical effects of a coordinated valuation methodology 206

10.5. What can OECD Transfer Pricing Guidelines tell about valuation in exit tax cases? 207
10.5.1. Delineating the "actual transaction" in exit tax cases 207
10.5.2. Valuation effects of a fictitious sale 208
10.5.3. Valuation under actual circumstances of the case 209
10.5.4. Valuation for exit tax purposes is not an exact science 209

10.6. Exit tax valuation under the ATAD 210
10.6.1. Valuation at "market value" (article 5(6) ATAD) 210
10.6.2. Coordination of valuation (article 5(5) ATAD) 211

Part Three
National Reports

Chapter 11: Austria 215
Sabine Kirchmayr and Stefanie Geringer

11.1. Value creation and (individual and corporate) income taxation 215
11.1.1. Concept of "value" 215
11.1.2. Concept of "asset" 217
11.1.3. Value "creation": Determination of asset value upon creation and subsequent use 218
11.1.4. Value creation/income attribution 220
11.1.5. Value changes 223
11.1.6. Value recognition in case of non-market transactions 225
11.1.7. Importance of value creation in cross-border situations 226
11.1.8. Transfer pricing and value creation 229

11.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 231
11.2.1. Recent changes to national tax legislation 231
11.2.2. The perceived need to align international taxation and value creation 233

Chapter 12: Belgium 235
Enguerrand Marique and Karl Pauwels

12.1. Value creation and income taxation 235
12.1.1. Concept of "value" 235
12.1.1.1. The term "value" 235
12.1.1.2. Singular definition? 235
12.1.1.3. Different types of "value" 235
12.1.1.3.1. Assets used in a professional context 235
12.1.1.4. Concept of "value" that is most directly underlying the structure of income taxation 237
12.1.2. Concept of "asset" 238
12.1.2.1. "Asset" for tax purposes 238
12.1.2.2. Recognition for tax purposes and the relationship with private law and the accounting system 239
12.1.2.3. Relevance of the asset's function for its treatment under income tax law 241

12.1.2.4. Case studies: characterizing specific assets for tax purposes 241
12.1.2.5. Can the following examples (given by the 2017 OECD Transfer Pricing Guidelines) qualify as an asset for tax purposes? 244
12.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 245
12.1.3.1. Different tangible assets 245
12.1.3.2. Categories of intangible assets 246
12.1.3.3. Consideration into which asset category "data" falls or should fall 249
12.1.4. Value creation/income attribution 249
12.1.4.1. How are assets and income connected thereto attributed to a taxable person? 249
12.1.4.2. Assets' income attribution to multiple taxpayers 252
12.1.4.3. Recent tax developments with respect to AI 252
12.1.5. Value changes 252
12.1.5.1. Change of use, function or location of an asset with regard to value changes 253
12.1.6. Value recognition in case of non-market transactions 255
12.1.7. Importance of value creation in cross-border situations 255
12.1.7.1. Non-residents 255
12.1.7.2. Residents foreign income 258
12.1.7.3. Comparing "source" rules 259
12.1.8. Transfer pricing and value creation 259
12.1.8.1. General transfer pricing policy 259
12.1.8.2. 2017 OECD TPG 260
12.1.8.3. Residual profits 261
12.1.8.4. Value creation in case law 261

12.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 262
12.2.1. Recent changes to national tax legislation 262
12.2.1.1. New tax incentives 262
12.2.1.2. The "value creation" link 263
12.2.1.3. Public debate 264
12.2.2. The perceived need to align international taxation and value creation 265

Chapter 13: Brazil 267
Luís Eduardo Schoueri and Gabriel Bez Batti

13.1. Value creation and income taxation 267
13.1.1. "Value" as a core for the taxation of income in Brazil 267
13.1.2. The concept of asset in domestic law and its relevance for tax purposes 270
13.1.3. Accounting rules for determining the value of assets in Brazil 273
13.1.4. Normative rules to determine attribution of income in Brazil 275
13.1.5. Revaluation of assets and tax neutrality 277
13.1.6. Brazilian income tax law applied to non-market transactions 278
13.1.7. "Value creation" in cross-border situations: Brazilian limited approach 280
13.1.8. Brazilian transfer pricing rules: A new era is coming? 282

13.2. Digitalization of businesses and value creation: Impact on Brazilian tax legislation 284
13.2.1. Tax reform in Brazil as a chance to implement "value creation" 284

Chapter 14: China (People's Rep.) 287
Na Li

14.1. Value creation and income taxation 287
14.1.1. Concept of "value" 287
14.1.2. Concept of "asset" 289
14.1.3. Value "creation": Determination of asset value 290
14.1.3.1. Upon creation 290
14.1.3.2. Upon subsequent use 292
14.1.4. Attribution of assets and income 292
14.1.5. Value changes 293
14.1.6. Value recognition in case of non-market transactions 293
14.1.7. Importance of value creation in cross-border situations 294
14.1.7.1. Non-residents' income in China 294
14.1.7.2. Foreign income of Chinese residents 296

14.1.8.	Transfer pricing and value creation	297
14.1.8.1.	Transfer pricing rules in general	297
14.1.8.2.	Response to the 2017 OECD TPGs	298
14.1.8.3.	Residual profits	300
14.1.8.4.	Case law on the concept of "value creation"	301
14.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	301
14.2.1.	Recent changes to national tax legislation	301
14.2.2.	Alignment of international taxation and value creation	302
Chapter 15:	**Croatia** *Hrvoje Arbutina and Nataša Žunić Kovačević*	305
15.1.	Value creation and (individual/corporate) income taxation	305
15.1.1.	Concept of "value"	305
15.1.2.	Concept of "asset"	307
15.1.3.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	309
15.1.4.	Value creation/income attribution	311
15.1.5.	Value changes	312
15.1.6.	Value recognition in case of non-market transactions	312
15.1.7.	Importance of value creation in cross-border situations	314
15.1.8.	Transfer pricing and value creation	317
15.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	319
15.2.1.	Recent changes to national tax legislation	319
15.2.2.	The perceived need to align international taxation and value creation	320
Chapter 16:	**Czech Republic** *Radim Boháč, Michal Radvan and Petr Vodák*	321
16.1.	Value creation and (individual/corporate) income taxation	321
16.1.1.	Concept of "value"	321
16.1.2.	Concept of "asset"	322

16.1.3.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	324
16.1.4.	Value creation/Income attribution	326
16.1.5.	Value changes	326
16.1.6.	Value recognition in case of non-market transactions	328
16.1.7.	Importance of value creation in cross-border situations	330
16.1.8.	Transfer pricing and value creation	332
16.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	335
16.2.1.	Recent changes to national tax legislation	335
16.2.2.	The perceived need to align international taxation and value creation	340
Chapter 17:	**Denmark** *Louise Fjord Kjærsgaard, Henrik Guldhammer Nielsen and Katja Dyppel Weber*	341
17.1.	Value creation and (individual/corporate) income taxation	341
17.1.1.	Concept of "value"	341
17.1.2.	Concept of "asset"	342
17.1.3.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	344
17.1.4.	Value creation/Income attribution	345
17.1.5.	Value changes	346
17.1.6.	Value recognition in case of non-market transactions	347
17.1.7.	Importance of value creation in cross-border situations	348
17.1.8.	Transfer pricing and value creation	349
17.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	351
17.2.1.	Recent changes to national tax legislation	351
17.2.2.	The perceived need to align international taxation and value creation	352

Chapter 18: Finland 353
Timo Torkkel

18.1. Value creation and (individual/corporate) income taxation 353
18.1.1. Concept of "value" 353
18.1.2. Concept of "asset" 355
18.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 357
18.1.4. Value creation/Income attribution 358
18.1.5. Value changes 361
18.1.6. Value recognition in case of non-market transactions 364
18.1.7. Importance of value creation in cross-border situations 367
18.1.8. Transfer pricing and value creation 368

18.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 371
18.2.1. Recent changes to national tax legislation 371
18.2.2. The perceived need to align international taxation and value creation 373

Chapter 19: France 375
Nicolas Vergnet

19.1. Value creation and income taxation 375
19.1.1. Concept of "value" 375
19.1.2. Concept of "asset" 376
19.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 379
19.1.4. Value creation/Income attribution 381
19.1.5. Value changes 383
19.1.6. Value recognition in case of non-market transactions 385
19.1.7. Importance of value creation in cross-border situations 387
19.1.8. Transfer pricing and value creation 389

19.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 390
19.2.1. Recent changes to national tax legislation 390
19.2.2. The perceived need to align international taxation and value creation 393

Chapter 20: Germany 395
Matthias Valta and Timo Lemm

20.1. Value creation and (individual/corporate) income taxation 395
20.1.1. Concept of "value" 395
20.1.2. Concept of "asset" 396
20.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 397
20.1.4. Value creation/Income attribution 399
20.1.5. Value changes 400
20.1.6. Value recognition in case of non-market transactions 402
20.1.7. Importance of value creation in cross-border situations 403
20.1.8. Transfer pricing and value creation 406

20.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 409
20.2.1. Recent changes to national tax legislation and debates about the need of changes 409
20.2.2. The perceived need to align international taxation and value creation 412

Chapter 21: Greece 413
Katerina Perrou

21.1. Value creation and (individual and corporate) income taxation 413
21.1.1. Concept of "value" 413
21.1.2. Concept of "asset" 415
21.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 416
21.1.4. Value creation/Income attribution 417
21.1.5. Value changes 418

21.1.6.	Value recognition in case of non-market transactions	420
21.1.7.	Importance of value creation in cross-border situations	421
21.1.8.	Transfer pricing and value creation	423
21.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	424
21.2.1.	Recent changes to national tax legislation	424
21.2.2.	The perceived need to align international taxation and value creation	424
Chapter 22:	**Hungary** *Dániel Máté Kovács, Zsolt Szatmári and István Simon*	427
22.1.	Value creation and income taxation	427
22.1.1.	Concept of "value"	427
22.1.2.	Concept of "asset"	431
22.1.3.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	433
22.1.4.	Value creation/Income attribution	435
22.1.5.	Value changes	437
22.1.6.	Value recognition in case of non-market transactions	438
22.1.7.	Importance of value creation in cross-border situations	439
22.1.8.	Transfer pricing and value creation	441
22.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	443
22.2.1.	Recent changes to national tax legislation	443
22.2.2.	The perceived need to align international taxation and value creation	445
Chapter 23:	**India** *Divesh Chawla*	449
23.1.	Value creation and (individual/corporate) income taxation	449
23.1.1.	Introduction	449
23.1.2.	Concept of "value"	449
23.1.3.	Concept of "asset"	450

23.1.4.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	452
23.1.5.	Value creation/Income attribution	453
23.1.6.	Value changes	455
23.1.7.	Value recognition in case of non-market transactions	456
23.1.8.	Importance of value creation in the cross-border situation	456
23.1.9.	Transfer pricing and value creation	459
23.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	461
23.2.1.	Recent changes to national tax legislation	461
23.2.2.	Equalization levy	462
23.2.2.1.	EL on digital/online advertisement	463
23.2.2.2.	EL on e-commerce supply or services	464
23.2.3.	Goods and Services Tax ("GST")	464
23.2.4.	Significant economic presence	465
23.2.5.	Income from advertisement and data	467
23.2.6.	Withholding tax	467
Chapter 24:	**Italy** *Dario Stevanato*	469
24.1.	Concept of "value"	469
24.2.	Concept of "asset"	470
24.3.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	473
24.4.	Value creation/Income attribution	475
24.5.	Value changes	477
24.6.	Value recognition in case of non-market transactions	478
24.7.	Importance of value creation in cross-border situations	480
24.8.	Transfer pricing and value creation	482

24.9.	Recent changes to national tax legislation	484
24.10.	The perceived need to align international taxation and value creation	487
Chapter 25:	**Luxembourg** *Alain Steichen*	491
25.1.	Concept of "value"	491
25.2.	Concept of "asset"	494
25.3.	Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets	499
25.4.	Value creation/Income attribution	501
25.5.	Value changes	503
25.6.	Value recognition in case of non-market transactions	505
25.7.	Importance of value creation in cross-border situations	507
25.8.	Transfer pricing and value creation	509
25.9.	Digitalization of businesses and value creation: Impact on domestic tax legislation	511
Chapter 26:	**The Netherlands** *Ronald Russo and Cees Peters*	513
26.1.	Value creation and (individual/corporate) income taxation	513
26.1.1.	Concept of "value"	513
26.1.2.	Concept of "asset"	513
26.1.3.	Value creation: Determination of asset value upon creation and subsequent use – Approaches to different types of assets	515
26.1.4.	Value creation/Income attribution	516
26.1.5.	Value changes	517

26.1.6.	Value recognition in case of non-market transactions	518
26.1.7.	Importance of value creation in cross-border situations	518
26.1.7.1.	Dutch income of non-resident taxpayers	518
26.1.7.2.	Foreign income of resident taxpayers	520
26.1.7.3.	Academic literature	520
26.1.8.	Transfer pricing and value creation	522
26.1.8.1.	Introductory considerations	522
26.1.8.2.	Actual delineation of the controlled transaction: Functional analysis including analysis of risks	523
26.1.8.3.	Intangibles	524
26.1.8.4.	Residual profits and application of profit split method	525
26.1.8.5.	Case law on "value creation"	525
26.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	526
26.2.1.	Recent changes to national tax legislation	526
26.2.2.	Academic literature	527
Chapter 27:	**Spain** *Eva Escribano and Aitor Navarro*	529
27.1.	Value creation and (individual/corporate) income taxation	529
27.1.1.	Concept of value	531
27.1.2.	Concept of asset	534
27.1.3.	Value creation	537
27.1.4.	Value creation/Income attribution	537
27.1.5.	Value changes	538
27.1.6.	Value recognition in case of non-market transactions	540
27.1.7.	Importance of value creation in cross-border situations	540
27.1.8.	Transfer pricing and value creation	542
27.2.	Digitalization of businesses and value creation: Impact on domestic tax legislation	544
27.2.1.	Recent changes to national tax legislation	544
27.2.2.	The perceived need to align international taxation and value creation	547

Chapter 28: Sweden 549
Bjorn Westberg

28.1. Value creation and (individual/corporate) income taxation 549
28.1.1. Concept of "value" 549
28.1.2. Concept of "asset" 550
28.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 553
28.1.4. Value creation/Income attribution 554
28.1.5. Value changes 555
28.1.6. Value recognition in case of non-market transactions 557
28.1.7. Importance of value creation in cross-border situations 557
28.1.8. Transfer pricing and value creation 559

28.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 561
28.2.1. Recent changes to national tax legislation 561
28.2.2. Need to reform international tax law? 562

Chapter 29: Switzerland 565
Raoul Stocker and Patrick Schmid

29.1. Value creation and income taxation 565
29.1.1. Concept of "value" 565
29.1.2. Concept of "asset" 568
29.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 570
29.1.4. Value creation/Income attribution 573
29.1.5. Value changes 577
29.1.6. Value recognition in case of non-market transactions 579
29.1.7. Importance of value creation in cross-border situations 580
29.1.8. Transfer pricing and value creation 582

29.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 583
29.2.1. Recent changes to national tax legislation 583
29.2.2. The perceived need to align international taxation and value creation 584

Chapter 30: Turkey 587
Doğan Şenyüz, Emrah Ferhatoğlu and Güneş Yılmaz

30.1. Value creation and income taxation 587
30.1.1. Concept of "value" 587
30.1.1.1. Concept of "value" in income taxation 587
30.1.1.2. Types of "value" in taxation 589
30.1.1.3. Definition of income 590
30.1.2. Concept of "asset" 590
30.1.2.1. Types of assets and description of asset for tax purposes 591
30.1.2.2. Definition of intangible asset and examples of intangible asset 591
30.1.2.3. Certain intangible asset 592
30.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 594
30.1.3.1. Classification of assets 594
30.1.3.2. Classification of certain assets: Intangibles 594
30.1.3.3. Consideration of a specific intangible asset for taxation purposes: Data 595
30.1.4. Value creation/Income attribution 595
30.1.4.1. Asset and income attribution to a taxable person 595
30.1.4.2. Asset and income attribution to AI 596
30.1.5. Value changes 596
30.1.5.1. Specific circumstances where value changes "realized" 597
30.1.5.2. Value changes arising from connection between a person and business-owned asset 597
30.1.6. Value recognition in case of non-market transactions 597
30.1.7. Importance of value creation in cross-border situations 599
30.1.7.1. Source rules and connecting factors for income taxation 599
30.1.7.2. Income taxation of residents' foreign income 601
30.1.8. Transfer pricing and value creation 602

30.1.8.1. Definition and application of transfer pricing in the context of Turkish tax law 602
30.1.8.2. Transfer pricing rules on the analysis of risk 604
30.1.8.3. Definition of intangibles provided by transfer pricing rules 605
30.1.8.4. Income attribution approach for income from intangible property 606
30.1.8.5. Attributed transfer pricing methods for residual profits 606

30.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 607
30.2.1. Recent changes in national tax legislation 607
30.2.1.1. Withholding tax on Internet advertising services 607
30.2.1.2. Digital service tax 607
30.2.2. The perceived need to align international taxation and value creation 609

Chapter 31: Ukraine 611
Danylo Getmantsev

31.1. Value creation and (individual/corporate) income taxation 611
31.1.1. Concept of "value" 611
31.1.2. Concept of "asset" 615
31.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 617
31.1.4. Value creation/Income attribution 619
31.1.5. Value changes 622
31.1.6. Value recognition in case of non-market transactions 623
31.1.7. Importance of value creation in cross-border situations 624
31.1.8. Transfer pricing and value creation 624

31.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 627

Chapter 32: United Kingdom 629
Rachael O'Connor and Amy Lawton

32.1. Value creation and (individual/corporate) income taxation 629
32.1.1. Concept of "value" 629
32.1.1.1. References to value in income tax law 629
32.1.1.2. Definition of "value" 630
32.1.1.3. Different uses of "value" 630
32.1.1.4. "Value" and the structure of income taxation 630
32.1.1.4.1. Income tax 631
32.1.1.4.2. Capital gains tax 631
32.1.1.4.3. Corporation tax 632
32.1.2. Concept of "asset" 632
32.1.2.1. References to "asset" in income tax law 632
32.1.2.2. The recognition of an "asset" for income tax purposes 633
32.1.2.3. "Asset" function and income tax law 634
32.1.2.4. Data, market share, customer base and AI as "assets" under income tax law 634
32.1.2.5. Patents, know-how, trademarks, licences and goodwill as "assets" under income tax law 635
32.1.3. Value "creation" 637
32.1.3.1. Grown versus manufactured tangible assets 637
32.1.3.2. The nature of intangible assets and "value creation" 638
32.1.3.3. Data as an asset under income tax law 639
32.1.4. Value creation/Income attribution 640
32.1.4.1. The attribution of assets and income to taxable persons 640
32.1.4.2. The attribution of one asset to multiple taxpayers under income tax law 641
32.1.4.3. AI as a taxable person 641
32.1.5. Value changes 642
32.1.5.1. A change in function or location of an asset 642
32.1.5.2. A change in value and connected activities by identifiable persons (or lack thereof) 643
32.1.6. Value recognition in case of non-market transactions 644
32.1.7. Importance of value creation in cross-border situations 647
32.1.7.1. "Value creation" and taxation of non-residents 647
32.1.7.1.1. Income tax 647
32.1.7.1.2. CGT 647

32.1.7.1.3. Corporation tax 648
32.1.7.1.4. Non-resident landlords 649
32.1.7.1.5. UK land 649
32.1.7.1.6. Intangibles 650
32.1.7.2. "Value creation" and taxation of foreign income 651
32.1.7.2.1. Individuals 651
32.1.7.2.2. Companies 652
32.1.7.2.3. Foreign PEs 653
32.1.7.3. "Source rules" for inbound and outbound situations 653
32.1.8. Transfer pricing and value creation 654
32.1.8.1. UK approach to transfer pricing 654
32.1.8.2. The 2017 OECD TPG 655
32.1.8.3. The 2017 OECD guidance on functional risk analysis 655
32.1.8.4. Chapter VI of the 2017 OECD TPG: Intangibles 656
32.1.8.5. DEMPE approach 656
32.1.8.6. Residual profits 657
32.1.8.7. "Value creation" and transfer pricing cases 657

32.2. Digitalization of businesses and value creation: Recent changes to UK tax legislation 657
32.2.1. Recent changes through adoption of new taxes 657
32.2.1.1. Digital services tax 657
32.2.1.2. Diverted profits tax (DPT) 661
32.2.2. Tax developments and "value creation" 664
32.2.2.1. DST 664
32.2.2.2. DPT 665
32.2.2.3. Other taxes 666
32.2.3. Aligning international taxation and value creation 666

Chapter 33: United States 669
Shu-Yi Oei

33.1. Value creation and (individual/corporate) income taxation 669
33.1.1. Concept of "value" 669
33.1.2. Concept of "asset" 671
33.1.3. Value "creation": Determination of asset value upon creation and subsequent use – Approaches to different types of assets 673
33.1.4. Value creation/Income attribution 675
33.1.5. Value changes 676

33.1.6. Value recognition in case of non-market transactions 678
33.1.7. Importance of value creation in cross-border situations 678
33.1.8. Transfer pricing and value creation 681

33.2. Digitalization of businesses and value creation: Impact on domestic tax legislation 686
33.2.1. Recent changes to national tax legislation 686
33.2.2. The perceived need to align international taxation and value creation 687

Part Four
Appendix

Appendix: Questionnaire for National Reports 693

Chapter 1

General Report on Value Creation and Taxation: Outlining the Debate

Werner Haslehner and Marie Lamensch

1.1. Introduction

The central question that gave rise to this study of the connection between taxation and the notion of "value creation" has been the following: if the meaning of "value" and "value creation" is not clear either conceptually or practically – that is to say in national tax systems, how could an international tax reform reasonably be based upon it?

In the international context, proxies such as residence, "permanent establishment" or place of the income-generating asset have been used to locate value and income for tax purposes. However, in recent years, value creation (and its location) has been repeatedly used to justify an overhaul of the international tax framework. The OECD project to tackle base erosion and profit shifting (BEPS) focused on the notion of a realignment of taxation with value creation. In the wake of a broad discussion about the impact of digitalization on the global economy and the fair allocation of taxes between countries, new proxies such as sales, people or data have been presented as being more adequate to tax profits generated by digital activities, whether under income tax or other forms of taxation. Also, formulary apportionment proposals based on the idea that "value" is created independently from assets themselves and is impossible directly to attribute to particular locations have proliferated. In addition, new taxes taking a measurement of "use" of digital services as a basis to determine national tax bases in deviance from traditional criteria to delineate taxing rights in existing tax treaties based on the OECD Model have been proposed and implemented in an increasing number of countries.

The purpose of the work to which this short contribution acts as general report has been to explore the possible meaning(s) of value and value creation and its relationship to national and international taxation, including from an interdisciplinary perspective. This general report does not propose any particular normative answer to the question where income ought to be taxed and how tax revenue should be split between countries with a claim to

a share. Its aims are more modest: it proposes, first, to analyse the possible meaning of "value creation" in an effort to assess its viability as a criterion for the allocation of taxing rights. To this end, it aims to describe and disentangle the arguments that have been made by policymakers and in scholarship over the last few years with respect to that notion, both with respect to general tax theory and with respect to ongoing international tax reform efforts. It then, second, seeks to systematize the way in which national tax rules make use of the notion of "value", what its meaning is in national law and how this is reflected in the doctrines and approaches to both national and cross-border transactions.

This general report is structured as follows: Following this brief introduction, section 1.2. sets out the main difficulties with the concept of value creation as a basis to inform decisions on international tax policy, defending the idea that the notion may not be entirely without meaning, and, although it cannot be relied upon with anything approaching mathematical precision, it can be a useful guidepost to think about the location of taxation. Section 1.3. focusses on the actual use of the notion of value creation in international tax law and policy, exploring in turn the theoretical basis, practical implementation and more recent reform efforts at least some of which have been justified with the argument that taxation ought to be aligned with the place where value is created, while more recent proposals, seeing the limitations inherent to that concept, have attempted to move beyond it. Section 1.4. summarizes the findings of the comparative study based on national reports as to the relevance and meaning of "value creation" in national income tax laws. Showing some remarkable convergence in substance, it also reveals that national tax policy has hardly been touched by anything resembling a coherent concept of value creation to explain most decisions in income taxation. Section 1.5. offers a brief conclusion.

1.2. The meaning of "value" and "value creation"[1]

1.2.1. Theories of value and value creation

Economists have long tried theoretically to explain the creation and meaning of value of products and services. Broadly, these attempts can be divided in "objective" (or "intrinsic") and "subjective" value theories: where the former propose that value is a property of things that derives from the factors

1. This section relies largely on thematic reports in this volume by Haslehner (Ch. 2), Lamensch (Ch. 3), Fuest (Ch. 4) and Llinares (Ch. 9).

that bring that thing into existence (e.g. in the labour theory of value, the sum of necessary labour to produce a good), the latter base value on the subjective assessment by those who would acquire a good.

If there is no universal theory on the meaning of value as such, the understanding of the creation of value by organizational units (businesses) is similarly evolving; not least as a consequence of digitalization and the ability of businesses to operate in very different structural forms: classic value chains, value networks, value platforms, etc.

What emerges from this is, (i) that the creation of value in a complex and internationally integrated economy cannot be easily attributed to specific inputs, activities or territories; (ii) that the relative weight of the factors contributing to the creation of value are shifting as a function of the types of activities that are undertaken and the nature of the goods and services that are the "carriers" of the value in question. Concretely, under a firm theory approach to value creation, it is increasingly the creation, preservation and use of knowledge that can be identified as the relevant factors for the creation of surplus value, exacerbating the difficulty of "locating" value creation even under a production-based paradigm because of the spatial indeterminacy of such "knowledge".

1.2.2. Value creation and income taxation: A tenuous link

If value is difficult to define and describe, the link between the creation of value and the target of taxation that is of primary interest for this investigation is even more tenuous: value creation does not equal income, nor revenue. Although one could equate "value creation" with "value consumption" in a temporally open-ended model,[2] it does not correspond spatially, unless one dispensed entirely with the notion of value as something created by a process of production undertaken prior to any consumption.

Income corresponds to "value capture" more than "value creation"; this puts a question mark behind any logic that would align taxing rights with

2. That is to say, for something to be considered valuable, it must be valued by someone who is willing to pay for it; thus, in the absence of a positive valuation by a consumer, it is difficult to see that any value has been created. Consequently, all value that is created must also be "consumed" in this sense. *See* Wolfgang Schön's thematic report, Ch. 7 in this volume, who expresses that thought thus: "There exists no product value at all without the input provided by the production side. And this value will not be realized without the willingness of the market side to offer a consideration for the product."

value creation. Would it not be more convincing – and politically feasible – to tax especially situations of purely extractive rents: e.g. where a foreign company receives exclusive rights on the exploitation of easily accessible natural resources? Value capture is not to be confused with value extraction, however. In any free market transaction, each party to a transaction remains at least as well off as before, thus no value is "taken from" ("extracted") another party. The sum of "value" revealed (if not *created*) in a market transaction is always at least equal to the sum of income made in that transaction. Even in the extreme case of a producer who manages to capture the entire surplus value of a transaction from consumers, the benefit (= value) accruing to consumers will still (at least) match the producer's revenue, and thus income, as revealed through their willingness to pay for the good in question. This must be true even in cases of market failure (absent coercion): If the value accruing to consumers were lower than the price, they would not buy. It may thus be justified to postulate an inherent connection between income and value, even though the entity to whom the income accrues may not be justifiably labelled its "creator" in a strong sense.[3]

Somewhat counter-intuitively, the concept of value creation has at times also been used to underpin suggestions for rent-based rather than income-based taxation: broadly speaking, this would entail confining corporate taxation to exceptionally high returns on investment, which would be pursued by investors regardless of any tax burden. Yet the idea merely to tax rents, while appealing from a perspective of economic efficiency, is not very consistent with the idea of taxing where value is created. This is because a rent arises at least as often as a consequence of extraneous circumstances (e.g. monopoly rights) as it does in direct consequence of a creative act by the entrepreneur who captures that rent. To illustrate this point, consider the relationship between income and an economic rent: in neoclassical economic theory, rents are understood as income over and above a normal market return for investment, taking into account entrepreneurial effort, skills and risk taking by the taxpayer. More precisely, the concept can be further refined to distinguish between pure rents and quasi-rents, where the latter fulfil the definition of a rent, i.e. a return above that necessary to induce the relevant production factor into the production process, but do not

3. This illustrates also how a VAT – falling on the consumer who gains "value" from a transaction – could be understood as a tax that can be said to fall on the location where value is created, even though, of course, the tax base is quite different from any measure of that value: while the value truly accruing to the consumer is merely the difference between their intrinsic valuation of the consumed good and the price charged, VAT is levied on the expenditure incurred on occasion of the final sale. *See further* sec. 1.2.3. and the thematic report by Lamensch, Ch. 3 in this volume.

exceed long-run marginal costs and are thus essential to attract investors.[4] By contrast, a true rent is a return beyond the long-run marginal costs of production; these are not anathema to competitive markets, but arise even under conditions of full competition from diverging costs for competing producers: whoever has an "edge" (e.g. because of particularly fertile land or unique human genius) would be expected to earn such "pure rent" or "inframarginal profits".

However, such (rent-taxation) proposals may be understood not so much in relation to a value created by the taxpayer as in relation to value creation in a particular place. That is to say, they aim to tax rents "extracted"[5] from a country as a way of taxing in the place where territorially the value that is captured in the rent has its source (i.e. has been "created" there), typically referred to as a location-specific rent.[6] How does the idea of taxing a certain portion of income that can be so "localized" relate to the concept of value creation? At their foundation, the argument for taxing in that location is different from the idea of "value creation", at least if the latter is understood as an elaboration on the benefit principle, i.e. the idea that a right to tax is connected to the public goods provided by a state to a taxpayer. Rent-taxation proposals are by and large based on an economic efficiency framework (rather than an equity framework to which the "benefit principle" belongs). These proposals[7] thus take their primary reason for taxation at source from the fact that a tax can be levied there without distorting business decisions, and that it would thus be inefficient if no such tax were imposed on the profits. Yet that does not stand in the way of a possible reconciliation of both in a particular policy. For surplus value that can be clearly tied to a specific location – because it could by definition not be earned anywhere

4. *See* Joseph Bankman, Mitchell Kane and Alan Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits* (2019 Working Paper) p. 5; *see also* Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy*, 47 Intertax 12, 1019 (2019), who notes that taxing quasi-rents can have a detrimental effect on investment.

5. Note that the term "extraction" may be not entirely appropriate here, since one would generally assume that in the absence of the economic activity undertaken by the foreign investor (the "extractor"), no value would even be existent. If no pre-existing valuable resource is taken away, it is not clear that extraction is the right way to frame the capture of value here. To illustrate this with particular respect to the digital economy, digital service provision that relies on and exploits locally collected data does not really take away data from the location. In contrast to, say, oil, personal data is not a depletable resource.

6. For a brief discussion of these proposals, *see* sec. 1.3.3.

7. *See* the thematic report by Schön, Ch. 7 in this volume.

else – the claim that such value has been "created" in that place also has a strong intuitive appeal.[8]

Even if the link between value creation and income is tenuous, that is not necessarily a flaw in making one the criterion to allocate rights to tax the other: First, because any criterion to which such a decision can be tied must by necessity be one that is not contained in the object of taxation; if critics argue that "taxing income where value is created" is meaningless, aiming to "tax income where income is created" would clearly be even more so. Second, because the claim to tax where value is created arguably does not derive from the idea that a business generates such value by itself in a particular location and that the mere artefact of that location of "production" falls within a particular jurisdiction. Instead, it should be understood as yet another reformulation of the benefit principle: it is because value has been created with the support of public goods provided by a particular jurisdiction that such jurisdiction derives a right to tax income that captures a part of the value so created. The question then becomes what form of state-provided benefit merits how great a taxing right for that state, i.e. how can a state be considered to co-create value giving rise to income. True, the notion of "taxing income where value is created" does not provide a clear (let alone simple) answer to that question.[9] But one may argue that it provides a framework to think about that allocation in a more structured way than a reference to the benefit principle alone.[10] And the benefit principle remains the strongest conceptual basis for the allocation of taxing rights among competing jurisdictions.[11]

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8. *See* Wei Cui, *The Digital Services Tax: A Conceptual Defense*, 73 Tax Law Review 1, 69-111 (2020); Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy*, 47 Intertax 12, 1009 (2019); *see also* Richard Vann, *Reflections on Business Profits and the Arm's-Length Principle*, in *The Taxation of Business Profits Under Tax Treaties*, 133 at 145–146 (Arnold, Sasseville and Zolt, eds., Canadian Tax Foundation 2003): "whenever a person derives and economic rent from a jurisdiction, that jurisdiction has a claim to tax".
9. Burgers, Ch. 8, sec. 8.3 in his volume, is certainly correct when she points out that, while "[p]ublic expenses enable companies to create value[,] [t]here is however no direct relation between the public expense and the amount of value creation."
10. For a critical view of the usefulness of the benefit principle *see* the thematic report by Schön, Ch. 7 in this volume, and earlier already Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax J., 67, at 75-77 (2009), Journal Articles & Papers IBFD.
11. *See* Mitchell Kane, *A Defense of Source Rules in International Taxation*, 32 Yale Journal on Regulation 315 (2015); Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy*, sec. 5.1.4. (IBFD 2018), Books IBFD; Eva Escribano, *Jurisdiction to Tax Corporate Income Pursuant to the Presumptive Benefit Principle: A Critical Analysis of Structural Paradigms Underlying Corporate Income Taxation and Proposals for Reform* (Kluwer

If a company creates value by making use of personal data of a state's citizens, can one see that state as contributing to the creation of that value? Perhaps in the sinister sense that it permits the company to exploit that data through (a lack of) legal regulation; or by providing the IT infrastructure that allows the company to have access to such data; or by allowing its citizens freely to access the Internet. Without an obvious default scenario, it is clear that all value creation requires at least tacit support from any jurisdiction which can exercise its jurisdiction in a way that would meaningfully affect the value-creation process. But the situation differs noticeably from that where a country provides a benefit in the form of infrastructure, access to resources (including an educated workforce) or even legal protection of intangible assets. What is clearly not required, in this framework, is a physical presence in a country for it to claim a taxing right. The issue of international tax reform proposals and their relationship to the concept of value creation is further explored *infra* at section 1.3.

Lastly, a standard question for the assessment of any tax policy must be that for the relevance of tax incidence. Does it matter, for purposes of the link between value creation and income taxation, who economically the tax falls on? After all, if income tax does not, in fact, burden the person who earns that income, but is shifted to someone else, does it not undermine the above-established link between the person who creates value (and thus earns income) and the justification for imposing a tax on that person in a particular jurisdiction? Indeed, as acknowledged, whoever "creates value" does not necessarily end up with commensurate income; equally, whoever pays tax on their "income" does not necessarily end up bearing the burden of that tax. However, once the decision to tax income has been made, taking "value creation" as a proxy for the allocation decision is not unreasonable, as income at least partly reflects the created value's capture in the hands of the person earning the income. It is worth noting that income does not even reflect the entirety of the surplus value that emerges in a transaction, and since the part captured by the consumer (the difference between the market price and their actual valuation of the good or service they purchase), which is not considered income, is the basis for any economic incidence of

2019); Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy*, 47 Intertax 12, 1005 (2019); note that, with Hongler, we understand the benefit principle primarily as a "justification-to-tax" and "limitation-to-tax" principle rather than one that gives direct answers as to a correct allocation key for taxing rights, *see* Peter Hongler, *Justice in International Tax Law*, 11.6. (IBFD 2019), Books IBFD. In this sense, it is closely linked to the "source principle". Indeed, Hongler refers to the "source principle" as the idea that "taxation should occur where value is created" (id., 11.5.1).

the income tax on the consumer, that tax is in any event still tied to the value either party captures in a market transaction.

1.2.3. Value creation and VAT: Is there a link?[12]

Does “value creation” amount to “value addition” and how important is “value creation” under the value added tax system (VAT)?

VAT is in principle levied on the subjective value of a transaction, or more precisely on the counterparty “objectively” paid to the supplier (i.e. the value actually received in each specific case, possibly in kind)[13] but corresponding to the “subjective” value that the customer agreed to pay in return for the good or the service, based on his/her “perceived value” of the good or service and not to value estimated according to objective criteria.[14] A corrective might apply, based on the “open market value” (without it being clear whether this concept is akin to the arm’s length standard in direct taxation) in the case of transactions between related entities.[15] But even when that is the case, the corrected amount would only be levelled up to the “perceived value” attributed to a good or service in a given market.

VAT merely seeks to tax final consumption but is levied throughout the production chain with a view to increase effectiveness. It may be expected that value is *being added or created* at each step of the production and distribution chain, either in the form of an improvement/transformation or a higher price. As such, however, there is no link with the *effective addition of value* and the levy of the tax as it is only the objective payment of a counterparty for a good or service that triggers the payment of the tax. VAT is indeed due whenever a supplier (qualifying as a taxable person for VAT purposes) supplies a good or a service against counterparty. This, even when the supply is made at a loss (e.g. sales period) and/or when there is a reduction of value of the supplied good or service (e.g. used goods), except in very specific

12. This section relies on the thematic report by Lamensch, Ch. 3 in this volume.
13. Art. 73 VAT Directive.
14. C-154/80 *Coöperatieve Aardappelenbewaarplaats*, para. 13; C-258/95, *Fillibeck*, para. 13; C-412/03 *Hotel Scandic Gåsabäck*, para. 21, C-285/10, *Campsa Estaciones de Servicio*, para. 28, C-69/11 *Connoisseur Belgium BVBA v. Belgium*; C-89/81 *Hong Kong Trade*, para. 13, C-230/87 *Naturally Yours Cosmetics*, para. 16, and C-126/88 *Boots Company v. Commissioners of Customs and Excise*, para. 19; C-621/10 and C-129/11, *Balkan and Sea Properties et Provadinvest*.
15. Art. 80 VAT Directive. “Open market value” is defined in art. 72 VAT Directive.

cases where an exemption[16] or a special scheme[17] might apply that takes into consideration the absence of value addition.

It should also be kept in mind that the place where value was added to a product of service also does not determine in any way the place where *final* taxation takes place, as only the Member State of final consumption (expenditure) is in principle entitled to a net tax. There is no apportionment with other Member States depending on whether value might have been added or removed earlier in the transaction chain. The Member State of final consumption thus "takes it all". It will not be the case only when suppliers in the chain are – by exception – not entitled to a full right of deduction (either because they are exempt or because the right to deduct is capped in national legislation) or are not able to recover it from a foreign administration (e.g. because the amount at stake is too low or because of administrative deficiencies). In these cases (where we can argue that the VAT system is deficient from a neutrality perspective) other states than the state of final consumption will retain an amount of VAT. But it again does not mean that these are states where (most or all of) the value has been added in these states.

In her report on Value Creation and VAT, Lamensch also highlights the issue of the lack of enforcement jurisdiction in destination-based system, i.e. the lack of means of control and enforcement on non-resident taxpayers, which is a well-known problem in the area of VAT. It is acknowledged in Chapter 6 and Annex C of the Final BEPS Report on Action 1[18] and in the literature.[19] It was also highlighted by a recent report of the European Court of Auditors that identifies it as a structural weakness of the centralized VAT collection system in place in the European Union for electronic services since 2003

16. The supply of buildings is in principle exempt, except in the case of new buildings and the CJEU clarified that the exemption is justified by the absence of significant added value. CJUE, 16 Nov. 2017, C-308/16 *Kozuba Premium Selection*, ECLI:EU:C:2017:869, para. 31.

17. A special scheme applies for used goods sold by a reseller that acquired the used good from a non-taxable person (or assimilated to). In such case the reseller may apply the VAT only on the margin (and not on the whole price of the resold good). This scheme primarily seeks to prevent tax cumulation but in effect allows to take into consideration a smaller tax base in the case of used goods.

18. *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report.

19. *See*, e.g., Walter Hellerstein, *Jurisdiction to Impose and Enforce Income and Consumption Taxes: Towards a Unified Conception of Tax Nexus*, in *Value Added Tax and Direct Taxation* (M. Lang, P. Melz and E. Kristoffersson eds., IBFD 2009), Books IBFD; Marie Lamensch, *Is There Any Future for the Vendor Collection Model in the 21st Century Economy?*, 27 Intl. VAT Monitor 3, 182-185 (2016), Journal Articles & Papers IBFD; M. Merkx, *The wizard of OSS: effective collection of VAT in cross-border e-commerce*, Inaugural Lecture, Rotterdam Erasmus University (February 2020).

Notes

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