THE "VALUE CREATION" QUESTION HAS ESCAPED THE NEW PILLAR 1 MOUSETRAP

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> *Ho lwana badula-mmoho*
>
> (Sesotho proverb, loosely meaning "Those who stay together often quarrel".)

When a Mosotho or a Sesotho speaker says "stay together," they usually mean "live together." By this terminology, the Inclusive Framework of 137 countries that agreed in October to adopt the two-Pillar approach to taxing the digital economy has also agreed to cohabit the role of global tax administration. The final details of the new arrangement have yet to be concluded, but one of the policy imperatives that led the world's tax authorities to this point has yet to be addressed by the Pillar 1 approach. Among other reforms, Pillar 1 replaces the arm's length standard with a formula-driven profit allocation mechanism for multinational companies with worldwide sales greater than €20 billion.

The path that led to the adoption of the new Pillar 1 taxing right began with the O.E.C.D./G-20 finance ministers committing to a plan calling for the allocation of profits to jurisdictions where value is created.[1] Since that decision was reached, much has been written about the vague and undefined nature of "value creation" as a foundational element of international tax policy on transfer pricing.[2] This has not stopped the term from being codified in certain O.E.C.D. transfer pricing compliance requirements.[3] Most important, for companies that are not required to conform to the formula-driven approach of Pillar 1, "value creation" remains the central foundational feature of the controlling policy idea.

This unresolved point all but guarantees an ongoing quarrel over transfer pricing policy for the portion of global companies that are not part of the group of large multinational companies that will be governed by Pillar 1. This group consists of most of the world's multinational companies by count, not by revenue. They will face conflicting definitions of the term "value creation" that almost certainly exist among those tax administrations that have chosen to stay together.

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1. OECD, Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p.20 (2013).
2. See for example, M.P. Devereux & J. Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, Eur. Tax Policy Forum Policy Paper, (31 July, 2018), J. Schwarz, *Value Creation: Old wine in new bottles or new wine in old bottles?,* Kluwer International Tax Blog (21 May, 2018), Allison Christians, *Taxing According to Value Creation*, 90 Tax Notes International, (June 18, 2018).
3. OECD (2014), Guidance on Transfer Pricing Documentation and Country-by-Country Reporting, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

Having lived with this practical uncertainty in a professional capacity for some time, I was intrigued to read the opening chapters of Mark Carney's *Value(s)* that adopted a definition of the troublesome term and helpfully described its origin in rough terms. At about the same time, I happened upon a paper by a staunch proponent of the arm's length principle and a number of co-authors[4] that proposes to solve the "value creation" problem by swinging a wedge pulled from the cooperative game theory golf bag to split profit as an outcome rather than quantify value creation, thereby promising the all-but-certain popular demise of the arm's length principle in favor of just about anything else. As long as the term "value creation" is central to multilateral guidance, it will continue to be used variously in its current undefined form by tax authorities and multinational companies to justify their transfer pricing positions, and quarrel will continue to be the norm.

Faced with these competing reading options, I decided to revisit the scribblers of political economy that first used the "value creation" term that has now taken its place in policy through generations of teachers and students to see if a practical meaning could be found. I immediately encountered what we now know to be a garden variety cognitive bias in economics, namely that your view on certain issues depends on your membership (whether known or not) in a school of thought.[5] We can add this cognitive bias to the list of past discoveries reported in *Insights*.[6]

It is also worth noting that the definition of "value creation" assumed by the O.E.C.D. members, many of whom trace the origins of their political economy to the traditions of modern Western civilization, may be predisposed to conflict with the fundamental views of the rest or the world (the O.E.C.D. non-member states that are part of the Inclusive Framework) that may understand "value creation" differently.

> *Sefate se tsejwa ka ditholwana*
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> (Sesotho proverb, loosely meaning "A tree is known by its fruit.")

If the "value creation" policy concept is the proverbial fruit, then the O.E.C.D.-member drafters that employed the term are most likely to be found sitting in the shade of a tree of either the classical or neoclassical species.

Classical theories of value developed from the time of Aristotle held that the idea of value creation coincides with need for a supply or a commodity and the utility from consuming the supply or the disutility from being without it. A thing was valuable if it was viewed as such in the societal context, if it advanced the national interest, or if it glorified a higher power.

Labor theories of value later refined and expanded by Smith, Ricardo, and Marx began with agricultural production and concentrated on the labor required to produce a good. Value creation occurred through the use of labor. With industrialization, labor remained the key source of value creation as labor was used to produce machines. Labor inputs were used to create surplus, creating a link at the time between labor and profit. Certain sources of profit such as usury and profit from exchange or trade

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4. Shapley, "Value: A Fair Solution to the Value Creation Puzzle in Transfer Pricing?" in *TaxNotes*.

5. See, for example, Javdani, Mohsen and Chang, Ha-Joon, "Who Said or What Said? Estimating Ideological Bias in Views Among Economists," (September 1, 2019). Available at SSRN.

6. See, generally, Volume 5, Number 5 of *Insights* (June 2018).

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were not counted as value creation, owing to moral or societal constructs of the time, or due to the fundamental controlling assumption that labor was the genesis of all value.

The Aristotelian concept of utility was later further developed and elevated to define the neoclassical definition of value creation in response to Ricardo and Marx. Value creation became synonymous with consumer utility, or the value placed on a good in an exchange and has been taught in economics and business programs in the tradition of Marshall, Walras, and Pareto for the last century. Trading off utilities and prices at the margin, and using aggregating principles to explain company, industry and macro activity we observe and expect is representative of the current mainstream.

Thinking of an international tax structure from a bygone era that uses an entity resident in a low-tax jurisdiction to hold intangible property and do nothing else offends both the classical and neoclassical definitions, as both the production and market locations associated with value creation are located elsewhere. Thought of this way, either Western view of value creation achieves the O.E.C.D./G-20 goal of frustrating the allocation of profit to tax havens.

The "value creation" policy concept however appears ill-equipped to go further and answer any other questions concerning profit allocation. Pillar 1 resolves the issue by stipulating an answer. If nothing else has been gained from transfer pricing policy reform efforts, tax authority positions may now at least be classified as classical, neoclassical, or other.

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