

ALTERNATIVE TO BEPS? DESIGNING A DESTINATION- BASED CORPORATE TAX

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ALTERNATIVE TO BEPS? DESIGNING A DESTINATION- BASED CORPORATE TAX

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LIMITATIONS OF CURRENT INTERNATIONAL TAX SYSTEM

- International allocation of corporate taxing rights primarily residence-based, with source-basis taxation being exception for particular types of income
 - Influence of OECD model convention
 - Many traditionally most traditionally capital-importing countries have amended their legislation to use residence as main connection factor
- International tax allocation system gives rise to many difficulties:
 - System regarded as out-dated:

“[The international tax system is a] flawed miracle”

R Avi-Yonah, 1996

LIMITATIONS OF CURRENT INTERNATIONAL TAX SYSTEM

- Based on residence and source principles started in the 1920s and consolidated worldwide mainly due to influence of OECD Model
- No longer suited for today's globalised economy, given levels of mobility of factors of production, primarily capital
- Extreme levels of legal complexity:
 - OECD Model Convention Interpretative Guidelines (updated on a regular basis)
 - High levels of litigation, involving significant sums and high administrative costs
- Why maintain current system?
 - “Immobilism” and attachment to existing system / *status quo* bias – no-one likes change!

A. Schindel and A. Atchabahian, “Source and Residence: A New Configuration of These Principles – General Report” (2005) *Cahiers de Droit Fiscal International* 90A

LIMITATIONS OF CURRENT INTERNATIONAL TAX SYSTEM

- Revenue protection by developed countries
 - emphasis of the system on residence-based taxation
- Two types of proposals for amending the current international allocation system
 - Proposals for relatively minor alterations to the current system – which usually means a bigger emphasis on source-based taxation, or anti-avoidance rules (BEPS)
 - Proposals for a more radical approach, advocating the complete substitution of the current system, by a new method of allocating or calculation of taxing rights at international level

OECD, Addressing Base Erosion and Profit Shifting (BEPS) (OECD, 2013)

OECD, Action Plan on Base Erosion and Profit Shifting (BEPS) (OECD, 2013)

PROPOSALS FOR IMPROVEMENT OF CURRENT INTERNATIONAL TAX SYSTEM

- Introducing amendments to the current international corporate tax system:
 - Origin-based taxation (Kemmeren, 2006); new definition of source-based taxation for e-commerce (Pinto, 2009); Source-based taxation, with progressivity (de Wilde, 2012)
 - OECD BEPS (2013)
 - Will any of these proposals work? Minor changes to an out-dated system, unsuitable for globalised economy
- “Conceptual problems in profit splitting”
 - In a globalised world, where new business models proliferate, and production is distributed across different countries, is where is the source?

E.C.C. Kemmeren,
“Source of Income in
Globalizing Economies:
Overview of the Issues
and a Plea for an Origin-
Based Approach” (2006)
*Bulletin for
International Fiscal
Documentation* 60(11)

D. Pinto, *E-Commerce
and Source-Based
Income Taxation* (IBFD,
2003)

PROPOSALS FOR IMPROVEMENT OF CURRENT INTERNATIONAL TAX SYSTEM

- It is common today for different stages of production to take place in different countries, which of these should be deemed to be the place of taxation
- Are source-based allocation rules are still appropriate for the 21th century economy?
- “Always one-step behind”
 - Corporate tax rules always catching-up with reality
 - BEPS deals with the symptoms, not causes of base erosion and profit shifting – so long as incentives are not removed, symptoms will reappear
 - BEPS as short-term, temporary, solution

Only fundamental, radical change to current international corporate tax system can offer long-term solution

PROPOSALS FOR NEW INTERNATIONAL TAX SYSTEM

- Only fundamental, radical change to current international corporate tax system can offer long-term solution
- Only two main proposals on the table for fundamental change:
 - Formula apportionment: used nationally in US, Mexico; proposed in EU, as Common Consolidated Tax Base (CCCTB)
 - Destination-based tax: abolishing residence and source principles, substituting them by destination principle

M. Devereux and S. Loretz, "Increased efficiency through consolidation and formula apportionment in the European Union?" (2008) *Oxford University Centre for Business Taxation Working Paper Series*, WP 08/12

C. Fuest, "The European Commission's Proposal for a Common Consolidated Tax Base" (2008) *Oxford University Centre for Business Taxation Working Paper Series*, WP 08/23

PROPOSALS FOR NEW INTERNATIONAL TAX SYSTEM

- Is formula apportionment the solution?
 - Many difficulties are directed at formula apportionment, mostly based on US experience (designing formula, lobbying, etc)
 - In EU CCCTB process seems dormant for time being – and indication that even it goes ahead not all countries will participate
 - Main disadvantage of formula apportionment is need for global agreement
- What about destination-based taxation?
 - Initial proposals for a destination-based tax corporate tax system are 15 years old

L. Bettendorf et al,
“Corporate tax consolidation and enhanced cooperation in the European Union”
(2010) *Oxford University Centre for Business Taxation Working Paper Series, WP 10/01*

PROPOSALS FOR NEW INTERNATIONAL TAX SYSTEM

- Consumption-based taxation – legal proposal on taxation of corporations country of consumption of the goods or services provided by those corporations, as means of combating harmful tax competition and use of tax havens (Avi-Yonah, 2000)
- Market-access-based taxation – legal proposal for taxation at country where goods or services are sold (Fernandes Oliveira, 2007)
- Destination-based corporate tax – economic model for taxation at country of destiny of goods and services (Auerbach, Devereux, Simpson, 2009)

R. Avi-Yonah,
“Globalization, Tax
Competition, and the Fiscal
Crisis of the Welfare State”
(2000) *Harvard Law Review*
113(7)

A. Auerbach, M. Devereux
and H. Simpson, “Taxing
Corporate Income” in J.
Mirrlees et al (eds.),
*Dimensions of Tax Design:
The Mirrlees Review*
(Oxford: Oxford University
Press, 2010)

PROPOSAL FOR DESTINATION-BASED TAXATION

- Why would it be better than source or residence-based taxation?
 - Two criteria for an international system of taxing corporate profit which aims to maximise total welfare:
 - (1) to identify a location of taxation which creates minimum distortion to the economic behaviour of multinational companies, to the ownership of assets and to competition between companies selling in the same market; and
 - (2) to identify a location of taxation that has jurisdiction to tax, from both a substantive perspective, and an enforcement perspective (legitimacy to tax, and possible to enforce taxation)

M. Devereux, "Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations" (2008) *Oxford Review of Economic Policy* 24(4)

M.P. Devereux, "Issues in the Design of Taxes on Corporate Profit" (2012) *National Tax Journal* 65(3)

PROPOSAL FOR DESTINATION-BASED TAXATION

- Criterion (1):
 - Key to identifying an appropriate location to minimise economic distortions is in identifying the mobility of different factors
 - Not all activities are equally mobile: consumers and customers tend to be immobile
 - If consumers and customers are immobile, then taxing the income in the place of sale, while giving relief for costs in the place in which they are incurred, avoids all of the distortions referred
 - DBCT would meet requirements of criterion 1 – a considerable achievement, HOWEVER...
- How about Criterion (2)?

How such a tax could be collected? In particular how could it be designed in order to meet the requirements of criterion 2?

DESIGNING A DESTINATION-BASED CORPORATE TAX

- VAT as starting point for designing a DBCT:
 - DBCT tax base = to VAT tax base, except for treatment of labour costs: deductible under the DBCT, but not under VAT
 - It may seem straightforward to implement a tax which is very similar to VAT, however:
 - Different treatment of labour costs raises some issues
 - DBCT levied like existing corporate taxes, VAT levied on basis of invoice-credit method
 - Existing VAT rules for cross-border trade are far from straightforward

R. de la Feria, “Place where the supply/activity is effectively carried out as an allocation rule: VAT v. Direct taxation” in M. Lang et al (eds.), *Value Added Tax and Direct Taxation – Similarities and Differences* (Amsterdam: IBFD, 2009)

DESIGNING A DESTINATION-BASED CORPORATE TAX

- Whether a DBCT is achievable / desirable in practice is dependent on whether the country of destination has the jurisdiction to tax corporate profits arising from sales in its territory
- Jurisdiction to tax can be divided into:
 - Substantive jurisdiction: legitimacy to tax, i.e. a connection between what is being taxed and the country imposing the tax that is sufficiently strong to legitimise that tax
 - Enforcement jurisdiction: ability to tax, i.e. whether the country has effective legal and implementing means of collecting the proposed tax

W. Hellerstein, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" (2003) *Georgia Law Review*, 1-39

DESIGNING A DBCT: SUBSTANTIVE JURISDICTION

- Is it legitimate for the country of destination to tax corporate profits arising from sales in its territory? Is the connection sufficiently strong to legitimise taxing rights?
 - Are sales the real origin of corporate income? Without sales there would be no profits to tax
 - Recent tax scandals involving Starbucks, Amazon or Google highlight significance of this connection: they are being criticised precisely for not paying tax where they are making sales
 - This is not to say that destination is necessary more legitimate basis to tax than source or residence – but it is as legitimate as

R. de la Feria, “Why Vodafone did not have to pay UK tax on the Verizon deal”, *The Conversation*, 4 September 2013 (most read online article on that day)

<https://theconversation.com/why-vodafone-did-not-have-to-pay-uk-tax-on-the-verizon-deal-17788>

DESIGNING A DBCT: SUBSTANTIVE JURISDICTION

- Inter-nation equity considerations:
 - Under this principle each country should be allocated an equitable share of the tax base from cross-border transactions
 - It must be acknowledged that substitution of the current rules by a DBCT will have an impact: some countries will gain, others will lose out
 - Impossible to say with certainty how revenues would be re-allocated under DBCT – too many variables – but important to keep a few points in mind:
 - This paradigm shift will not necessarily be unfavourable to developing countries: developed countries will most likely benefit; but so will big developing countries

R. Musgrave and P. Musgrave, “Inter-Nation Equity” in *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (University of Toronto Press, 1972)

DESIGNING A DBCT: SUBSTANTIVE JURISDICTION

- Current international tax system is problematic also for developing countries, particularly BRIC countries (some evidence of profit shifting)
- Who will lose is not as obvious as it might appear:
 - Assumption that developing countries with smaller populations will lose
 - However, sub-Saharan countries import as much as they export
 - Of course contra-factual is how much revenue is collected under current system, but level of imports is still a good indication
- For countries with strong natural resources the change from source to destination-based taxation might be problematic – however, nothing prevents domestic legislator from approving natural resources tax (increasingly frequent worldwide)

C. Fuest and N. Riedel,
Tax evasion, tax
avoidance and tax
expenditures in
developing countries
(2010) *Oxford University
Centre for Business
Taxation Working Paper
Series, WP 10/12*

DESIGNING A DBCT: SUBSTANTIVE JURISDICTION

Developing countries / emerging economies seem to be also instinctively asking for destination-based taxation:

India: all signed DTTs include a source rule for services (very broadly defined) which taxes where payer is located = destination-based tax, customer location proxy

UN: considering several amendments to allocation of taxing rights for services in the UN model convention, including possible introduction of rule similar to India

LATAM countries (Brazil, Argentina, Peru, Mexico): domestic legislation taxes where payer is located = destination-based tax, customer location proxy; particularly relevant since it excludes significant portion of services of DTTs, and has small treaty coverage

DESIGNING A DBCT: TAX BASE

- Most considerations on tax base have been dealt with in Auerbach, Devereux and Simpson (2008)
- Financial transactions:
 - Under VAT financial transactions are regarded as “too-difficult-to-tax”, and thus usually exempt
 - Basic design of DBCT: levied on net cash flows associated with “real” as opposed to “financial” flows, leaving out therefore profits made by financial companies
 - Proposal for DBCT:
 - Meade Committee’s R+F base for financial companies, regulated by financial regulatory body / authority
 - R base for all other companies

Two issues require further consideration for design of DBTC:

- *Financial transactions*
- *SMEs*

DESIGNING A DBCT: TAX BASE

- SMEs
 - Only incorporated businesses or all businesses above a threshold? All business probably better, but we assume that existing tax distinction between incorporated and non-incorporated businesses will remain
 - Under DBCT existing distortions between these two businesses could be eliminated if an equalising element was introduced but that would essentially result in taxing personal income tax also on a destination-basis
 - With no equalising, would DBCT maintain existing distortions at same level, or increase size? Similar for imports; potential increase for exports BUT
 - In unilateral setting, distortion could decrease, if by virtue of the rate of destination-based tax now being de facto zero, the difference between the CIT rate and PIT rate would decrease.

R. de la Feria and B. Lockwood, "Opting for Opting In? An Evaluation of the Commission's Proposals for Reforming VAT for Financial Services" (2010) *Fiscal Studies* 31(2)

R. de la Feria and M. Walpole, "Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared" (2009) *International and Comparative Law Quarterly* 58(4)

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

- Does the country of destination have the effective legal and implementing means of collecting tax on corporate profits arising from sales in its territory?
 - Identifying destination
 - VAT uses legal proxies to identify destination – itself a legal proxy for consumption
 - How many proxies are used, or how complex the proxy chain is, will depend from system to system
 - Identifying place of taxation (destination) will often depend on various questions: who, what, to whom, where?
 - Equally a DBCT would have to use legal proxies to establish place/country of destination

Use of complex proxy chains or interlinked proxies should be avoided as far as possible

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

TANGIBLE PROXIES	INTANGIBLE PROXIES
(1) the location of goods	(4) the supplier location (location, residence, or place of business of the supplier)
(2) the location of land	(5) the customer location (location, residence, or place of business of the customer)
(3) the place of performance	(6) the consumer location (location, residence, or place of business of the person to whom the thing supplied is provided/rendered/delivered/received by)
	(7) the place of effective use or enjoyment of the supply

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

Proposal for identifying destination under DBCT:

Use customer location proxy as a rule for all transactions (goods and services; B2B and B2C) with few adjustments

No adjustment for e-commerce (location of customer proxy applied on basis of residence, not IP address)

Adjustment 1: B2B transactions where services are used by more than one establishment under internal recharge arrangement, arrangement should be deemed to be supply

Adjustment 2: B2C transactions there should be departure from main rule when applying that proxy would be too burdensome, e.g. supplies of services which requires physical presence of both supplier and customer in readily identifiable location

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

- Administrative obligations
 - Revenue rule (Government of India principle) as one of traditional principles of international tax law: absent agreement or limited exceptions, countries will not assist in collecting taxes for another country
 - Progressive demise of principle insofar as income taxes are concerned over the last decade: mutual assistance, exchange of information, etc
 - In VAT the demise of the revenue rule and (implicit) proposals for its abolition as regards intra-EU trade started in 1980s
 - After many false starts, EU approved in 2008 a Mini-One-Stop-Shop (MOSS) for e-commerce: traders only have to register themselves in one Member State and declare all their sales in that country; exports are zero-rated on B2B, but VAT is charged at the rate of the country of destination on B2C

R. de la Feria, “Sections 103-106: VAT – Mini-One-Stop-Shop (MOSS)” (2014) *British Tax Review* 5

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

- MOSS was implemented in stages:
 - Initially applied to non-EU businesses with customers within more than one EU Member State
 - From 1 January 2015 it will apply to EU businesses operating in more than one EU Member State
- Big push to make MOSS work, primarily by European Commission: new legislation enhancing administrative collaboration between tax authorities, explanatory notes, extra guidelines, etc
- MOSS is a great *de facto* experiment:
 - For a general OSS for VAT, as envisaged by European Commission
 - For a DBCT...

MOSS / OSS presents great potential for DBCT:

- It avoids the problem of multiple registration
- Reduces potential difficulties arising from different treatment of labour costs under a VAT and a DBCT
- Prevents missing-trader fraud spreading from VAT to CIT

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

ADMINISTRATIVE OBLIGATIONS FOR COUNTRIES OUTSIDE THE COOPERATION GROUP

		EU COUNTRIES	NON-EU COUNTRIES
B2C	Goods	OSS (registration)	Physical borders
	Services	OSS (registration)	OSS (registration)
B2B	Goods	No relief	No relief
	Services		

DESIGNING A DBCT: ENFORCEMENT JURISDICTION

Proposal for administrative obligations / compliance under DBCT (international cooperation setting):

Implementation of a OSS for all companies engaging in cross-border trader

Residence country collects revenue due on behalf of destination country, taxing the corporate profits at the rate of the latter

Tax authorities of both countries do an aggregate reconciliation across all transactions in a given period

Enforcement jurisdiction is de facto delegated by destination country on residence country, whilst the substantive jurisdiction is kept by country B, which ends up receiving the tax revenue

DESIGNING A DBCT: INTERNATIONAL LEGAL OBLIGATIONS

- Unilateral / group introduction of DBTC would require consideration of existing international legal obligations:
 - EU law: Will companies in country applying DBTC be in a competitive disadvantage?
 - If so, introducing DBCT may constitute discriminatory measure
 - Even if discrimination, is it justifiable?
Coherence of the tax system: no intention on discrimination, but application of a completely new tax
 - Proportional? Suitable yes, necessary yes
 - WTO agreement: prohibits direct taxes based on destination, since they benefit exports

DESIGNING A DBCT: INTERNATIONAL LEGAL OBLIGATIONS

- This is an issue in every situation excluding full international cooperation (where alteration of WTO agreement would be feasible)
- What is a direct tax? direct / indirect taxes are outdated concepts, based on notions of incidence/remittance
- Difficulties over enforceability of WTO agreements
- DTTs: in international cooperation setting they would be redundant, but not in unilateral action
 - Validity of treaties signed with countries outside the cooperation group
 - International law status: monist vs dualist system

CONCLUSIONS

- In our proposal we take VAT as a starting point for designing and implementing a DBCT
- We consider the destination country's substantive and enforcement jurisdiction, as well as the scope of the tax
- Country of destination has substantive jurisdiction to tax: destination is as legitimate basis to tax as source or residence
- Substitution of current system by DBTC will have an impact on international revenue allocation, but it should not be assumed that developing countries will necessarily lose



CONCLUSIONS

- Enforcement jurisdiction is de facto delegated by destination country on residence country, which collects the revenue
- This design would decrease compliance costs, and limit fraud risk
- In unilateral setting, administrative obligations would work differently for those within the DBCT group, and those outside
- Existing legal obligations present challenges in an unilateral action setting, but can be overcome



CONCLUSIONS

- Paper demonstrates how a DBCT can be successfully designed and implemented in three scenarios:
 - International cooperation
 - Unilateral action
 - Mixture of the two: a small group of countries adopts the DBCT, whilst all others do not (most likely)

(Preliminary) Working Paper available at:

<http://www.sbs.ox.ac.uk/ideas-impact/tax/publications/working-papers/defining-and-implementing-destination-based-corporate-tax>

