DESIGNING AND IMPLEMENTING A DESTINATION-BASED CORPORATE TAX

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DESIGNING AND IMPLEMENTING A DESTINATION-BASED CORPORATE TAX

- International allocation of corporate tax rights traditionally based on two principles: source and residence
- However, in a globalised world economy both residence and source based taxation distort international trade to an extent that it is now difficult to argue for superiority of one over other
- Over last decade calls for radical departure from the existing rules have been gathering momentum, with proposals for a destination-based tax on corporate profit
- The aim of this paper is to consider how a destination-based corporate tax (DBCT) could be designed and implemented
DESIGNING AND IMPLEMENTING A DBCT: OVERVIEW

I. General Considerations on DBCT
II. International Allocation of Corporate Taxing Rights
   I. Traditional Dialectic of Residence vs. Source-Based Taxation
   II. Paradigm Shift: Destination-Based Taxation
III. Designing and Implementing a DBCT
   I. Substantive Tax Jurisdiction
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      I. Identifying Destination
      II. Administrative Obligations
      III. Fraud and Avoidance Considerations
III. Tax Base
IV. International Coordination vs. Unilateral Implementation
V. Conclusion
GENERAL CONSIDERATIONS ON THE DBCT

• Two criteria for an international system of taxing corporate profit, within a setting in which all countries aim to co-operate in implementing taxes 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.
GENERAL CONSIDERATIONS ON THE DBCT

– 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 pace 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...

– 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?
GENERAL CONSIDERATIONS ON THE DBCT

• 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
DESIGNING AND IMPLEMENTING A DBCT

• 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.
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.
DESIGNING AND IMPLEMENTING A DBCT: SUBSTANTIVE JURISDICTION

– This is not to say that destination is necessary more legitimate basis to tax than source or residence – but it is as legitimate

• 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
  – However, this paradigm shift will not necessarily be unfavourable to developing countries: developed countries will most likely benefit; but so will big developing countries
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
<table>
<thead>
<tr>
<th>TANGIBLE PROXIES</th>
<th>INTANGIBLE PROXIES</th>
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<tr>
<td>(1) the location of goods</td>
<td>(4) the supplier location (location, residence, or place of business of the supplier)</td>
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<tr>
<td>(2) the location of land</td>
<td>(5) the customer location (location, residence, or place of business of the customer)</td>
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<tr>
<td>(3) the place of performance</td>
<td>(6) the consumer location (location, residence, or place of business of the person to whom the thing supplied is provided/rendered/delivered/received by)</td>
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<td>(7) the place of effective use or enjoyment of the supply</td>
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DESIGNING AND IMPLEMENTING A
DBCT: ENFORCEMENT JURISDICTION

• However, use of complex proxy chains or interlinked proxies should be avoided as far as possible

• Proposal for DBCT:
  – Use customer location proxy as a rule for all transactions (goods and services; B2B and B2C) with few adjustments
  – **Adjustment 1:** in B2B transactions where services are used by more than one establishment under internal recharge arrangement, that arrangement should be deemed to be a supply
  – **Adjustment 2:** in B2C transactions there should be a departure from main rule when applying that proxy would be too burdensome, e.g. supplies of goods where there are no physical borders, or supplies of services which requires physical presence of both supplier and customer in readily identifiable location
  – **No adjustment** for e-commerce (location of customer proxy applied on basis of residence, not IP address)
DESIGNING AND IMPLEMENTING 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, the EU approved in 2008 a Mini-One-Stop-Shop 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
DESIGNING AND IMPLEMENTING A DBCT: ENFORCEMENT JURISDICTION

- This feature presents great potential for DBCT:
  - It avoids the problem of multiple registration, without compromising the destination principle
  - It reduces potential difficulties arising from the different treatment of labour costs under a VAT and a DBCT

- Proposal for DBCT:
  - 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 AND IMPLEMENTING A DBCT: ENFORCEMENT JURISDICTION

– Fraud and avoidance considerations
  • Whilst it is usually said that VAT is self-enforceable, thus creating a minimum risk of fraud, this is not always the case
  • A particular problem within the EU since the abolition of fiscal frontiers has been the missing trader fraud
  • The missing trader fraud is a (unwanted) sub-product of the invoice-credit system, which would not apply to the DBCT
  • No tax is fraud-proof and the DBCT would not be exception: particular problem might be unregistered businesses on B2C transactions, but numbers unlikely to be significant
  • Avoidance within VAT is usually linked to existence of exemptions or reduced rates – both non-applicable within DBCT
  • Tax havens also unlikely to be a problem for DBCT – setting-up a company in a tax haven as an intermediary is unlikely to bring any benefits, for far as countries involved apply same form of tax
What is the scope of the DBCT?

- Financial transactions
  - Under VAT financial transactions are regarded as “too-difficult-to-tax”, and thus usually exempt
  - Basic design of the 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, which does incorporate financial flows
  - Which companies should be included in extended base? All companies regulated by financial regulatory body

Subjective scope

- Only incorporated businesses or all businesses above a threshold?
- All business would probably be better, but interaction with personal income tax would have to be considered
INTERNATIONAL COOPERATION VS UNILATERAL IMPLEMENTATION

- Proposal presented for DBCT assumes that tax is implemented by all countries worldwide.
- Would it be possible / desirable to implement such a tax unilaterally, whilst other countries continue to apply conventional CIT?
  - Particularly significant since global agreement is unlikely to be reached in advance.
  - The benefits to acting unilaterally not clear cut, but balance would seem to favour it: competitive advantage for domestic producers, strong location advantages to producing in country DBTC, limited revenue effects.
  - Would there be incentives for other countries to join? For smaller countries competing with country applying a DBCT there would be significant disadvantages in keeping convention CIT.
CONCLUSIONS

• Possible to design and implement a DBTC which would minimise economic distortions + be enforceable / workable

• There would be gains in international cooperation, but it is not essential

• There are incentives for a single country, or small group of countries to implement the DBTC in the absence of international agreements

• If a relatively large market was applied DBTC, there would be an incentive for other countries also to switch to such a tax