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# Designing and Implementing a Destination-Based Corporate Tax

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*The current international tax system based upon the principles of source and residence is no longer suited to a globalised world economy, and the fundamentals of the international tax system need to be re-examined. An R+F based cash-flow tax based on the principle of destination has been proposed as a suitable alternative to taxing corporations in an international setting. The aim of this paper is to discuss the legal and practical issues which would arise in the implementation of such a tax, namely how a destination-based tax could be effectively designed and implemented. For this purpose we draw on experiences with designing VAT systems worldwide. It is proposed that the destination principle should be implemented through use of the customers' location as the main legal proxy. We argue that the country where the customer is located has both the substantive jurisdiction to tax, i.e. the legitimacy to impose tax, and enforcement jurisdiction to tax, i.e. the effective legal and implementing means of collecting the proposed tax. As regards enforcement jurisdiction to tax, we propose that a one-stop-shop system similar to that being experimented in VAT as the most effective means of collecting tax. Other potential implementing issues are addressed, namely deductibility of expenses and tax credits, susceptibility to avoidance and fraud, treatment of financial transactions, and treatment of small businesses. We conclude that, if it were applied in an international cooperation setting, it would indeed be legitimate and administratively possible to implement a destination-based corporate tax.*

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## I. INTRODUCTION

The international allocation of rights to levy corporation tax has been traditionally based on two principles: source and residence. However, in a globalised world economy, where capital flows freely, and new economic realities dominate, both residence and source based taxation distort international trade and movement of capital and business. . In this paper, we start from first principles to consider radical reform of the international system. We begin with what we believe are two reasonable two criteria for assessing proposals for an international system of taxing corporate profit. We focus on a setting in which all countries aim to co-operate in implementing taxes to maximise total welfare. The two criteria are:

- (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, i.e. a sufficiently strong connection between the country and the profits to justify levying the tax, and an enforcement perspective, i.e. the ability to collect the tax at minimum costs, which minimises the opportunities for avoidance and fraud.

The key to identifying an appropriate location to minimise economic distortions is in identifying the mobility of different factors. A large company generates its profit from many activities. It needs investors – shareholders and creditors; a head office, and/or parent company; a variety of activities, including R&D, production, marketing and finance; and sales to third parties. A multinational company may site these activities in a large number of different countries. It makes little economic sense to ask where it makes its profit. All of these activities are *necessary* but not *sufficient* for generating profit. Indeed, the multinational company probably generates higher profit *because* it operates in many different countries.

However, not all of these activities are equally mobile. In particular, individuals tend to be less mobile than other activities. For example, the shareholders and customers of a multinational company are unlikely to shift their place of residence in response to taxation of the multinational's profit. By comparison, there is plenty of empirical evidence that companies locate their activities (and profit for the purposes of existing taxes) in lower-taxed jurisdictions. The benefit of associating tax with an activity that is not mobile is that the location will not change as a result of introducing the tax. These considerations therefore point to taxing the profit in the place of residence either of the shareholders or the customers.

In this paper, we consider a tax based in the place of the customer –a destination-based tax. It is important to note here that the point of first criterion is *not* to levy the tax in the place of consumption per se, but in a place where the relevant activity is relatively immobile. These may often be the same, but where they are different the distinction becomes important, as discussed below.

Specifically, we consider, proposals for a “destination-based cash flow” tax on corporate profit, which has been proposed elsewhere.<sup>1</sup> It has been established in a theoretical setting that, under certain conditions, a destination-based cash-flow tax would not distort the investment, financial, pricing or location decisions of multinationals.<sup>2</sup> Such a tax would have the following broad properties: immediate expensing of all investment expenditure; inclusion of net financial inflows in the tax base; and a zero rate of tax on exports, but a tax on all imports. The first two features essentially define the R+F-based cash flow tax of the Meade Committee.<sup>3</sup> IN a domestic context, the properties of this tax are well known; in effect, the government becomes a shareholder in the company – through deductions for expenditure it contributes a share of all costs, and it collects the same share of all income. It therefore does not distort investment and financing decisions in a domestic context, and for this reason it has been consistently advocated by economists for corporation tax reform.<sup>4</sup>

It is the third feature however that changes the location of taxation of profits from the international norm; it is also the key feature of value added taxes. Broadly, this third feature means that income from an export is taxed in the jurisdiction in which the customer purchases the good or service, rather than where the good or service is produced or provided. To the extent to which the location of a sale to a final consumer is fixed by the purchaser’s place of residence, then the tax on the income generated by a multinational company does not depend on the location of the company itself.

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<sup>1</sup> See, for example, R. Avi-Yonah, “Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State” (2000) *Harvard Law Review* 113(7), 1573-1676, at 1670-1671; S. Bond and M.P. Devereux. “Cash flow taxes in an open economy” (2002) *Centre for Economic Policy Research Discussion Paper Series*, Discussion Paper 3401; M.P. Devereux and P. Birch Sorensen, “The Corporate Income Tax: international trends and options for fundamental reform” (2006) *European Commission Economic Papers* 264; European Economic Advisory Group, *The EEAG Report on the European Economy* (CESifo Group Munich, 2007), Chapter 5, 121-32; A. Auerbach, M.P. 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), 837-893; A. Auerbach, “A Modern Corporate Tax”, *The Hamilton Project* (2010); A. Auerbach and M.P. Devereux, “Consumption and Cash-Flow Taxes in an International Setting” (2012) *Oxford University Centre for Business Taxation Working Paper Series*, WP 12/14; M.P. Devereux, “Issues in the Design of Taxes on Corporate Profit” (2012) *National Tax Journal* 65(3), 709-730.

<sup>2</sup> See S. Bond and M.P. Devereux (2002) and A. Auerbach and M.P. Devereux (2010), both above.

<sup>3</sup> Meade Committee, *The Structure and Reform of Direct Taxation*, (London: Allen and Unwin, 1978).

<sup>4</sup> We discuss below modifications of this basic tax base to encompass financial companies, which is based on Meade’s “R+F” base.

However, the tax has an asymmetric basis; although sales would be taxed in the purchaser's place of residence, expenses would receive tax relief in the place in which they were incurred. It might be thought that this would give an incentive to locate expenses in high tax countries. However, in theory at least, this should not occur. The reason is that the price of the intermediate goods or services used by the company would be affected by the tax. This is clearest to see if the intermediate goods or services were imported. In this case, the tax on the import would be exactly offset by the relief against tax available to the purchasing company. But the same would be true of intermediate goods and services supplied domestically; their price would also be driven up by the tax, so that there would be no distortion between domestically-sourced goods and services and imported goods and services. The tax would therefore not distort the location of production, or other activities of a company. In principle, at least, it therefore satisfies criterion 1.

This paper therefore sets out to consider how such a tax could be designed and implemented. The main focus in this paper is to consider the design and implementation issues if all countries agreed to coordinate on this tax as a new international norm. We make some comments on the issues arising if a single country, or group of countries, wished to implement the tax unilaterally; however, we discuss this in more detail in a follow-up paper.

Issues involved in transforming existing corporation taxes into R+F-based cash flow taxes are well known and we do not discuss them in any detail here; instead we focus on issues which would arise in implementing the third feature, the destination basis of the tax. The paper naturally draws heavily on the design of value added taxes, since they are already used in most countries, and there is a wealth of experience of dealing with international issues in their design.<sup>5</sup> However, the proposals set out below do not blindly follow VAT rules as implemented in Europe or elsewhere. Instead we go back to first principles to identify what features the tax should ideally have, and then consider how tax rules could be designed to meet such principles as closely as possible.

The remainder of the paper is organised as follows. Part II briefly summarises the theory of the optimal location of taxes on corporate profit, and relates that to existing practice; Part III sets out proposals for the legal design of a destination-based cash flow tax, if implemented in all countries. In this part of the paper we consider namely issues concerning substantive jurisdiction to tax, enforcement jurisdiction to tax, in particular administrative obligations and susceptibility to fraud and avoidance, and the scope of the tax, such as treatment of financial transactions and of small businesses.

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<sup>5</sup> Most recently addressed by the OECD in *OECD International VAT/GST Guidelines, Draft Consolidated Version*, February 2013. For further references see Part III below.

## II. CURRENT INTERNATIONAL ALLOCATION OF CORPORATE TAXING RIGHTS

Allocation of the right to tax the profit of multinational companies is done through international tax rules set out in national tax systems. In theory therefore each country is free to choose the jurisdictional connection that best suits its needs. However, complete sovereignty is subject to limitations, namely voluntary limitations imposed by the country itself, usually for economic policy or market-induced reasons; negotiated limitations through bilateral or multilateral conventions, such as Double Taxation Treaties (DTT); and externally imposed limitations, such as those imposed to countries listed as tax heavens.<sup>6</sup> Whether EU law limitations should be characterised as negotiated, or externally imposed limitations,<sup>7</sup> or – perhaps more importantly – whether they amount to an international tax regime, are controversial questions.<sup>8</sup> Regardless of the answer to these questions, however, in practice the principles underpinning international tax rules are similar worldwide, and date back to the work carried out by the League of Nations in the 1920s.

Concerned about avoiding double taxation and tax evasion – which it perceived to be intrinsically linked – the League of Nations initiated a process in the early 1920s that ultimately led to the first model tax convention in 1928.<sup>9</sup> Broadly based on an initial report carried out by four economists in 1923, the first model convention embraced the single tax principle, i.e. that all income should be taxed only once, and set-up the basic guidelines for allocation of taxing rights, i.e. the principles that should underpin the jurisdiction to tax income.<sup>10</sup> Arguably based on the benefits principle,<sup>11</sup> the work of the League of Nations established two main bases for income tax jurisdiction: residence and source. In the following decades residence-based and source-based taxation consolidated as two foundational principles of international allocation of taxing rights – due to a great extent to the influence of the OECD DTT model – to the point where there is a traditional assumption that they enjoy universal agreement.<sup>12</sup>

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<sup>6</sup> See C.E. McLure, “Globalization, Tax Rules and National Sovereignty” (2001) *Bulletin for International Fiscal Documentation* 55(8), 328-341, at 333.

<sup>7</sup> See 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), 961-1014, at 963-964.

<sup>8</sup> See R. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press, 2007), at Chapter 1, and references cited therein.

<sup>9</sup> League of Nations, *Double Taxation and Tax Evasion*, Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, G.216.M.85.1927.II., April 1927.

<sup>10</sup> For a comprehensive historical analysis see M.J. McIntyre “Developing Countries and International Cooperation on Income Tax Matters: An Historical Review”, 2005, mimeo.

<sup>11</sup> See R. Avi-Yonah n. (...) above, at 11 *et seq*; on the benefits principle see Part III, section A below.

<sup>12</sup> M.J. Graetz, “The David R. Tillinghast Lecture – Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies” (2000-2001) *Tax Law Review* 54, 261-336, at 269.

## A. Residence vs. Source-Based Taxation

The terms residence and source are commonly used, but can have different meanings, especially when comparing economic and legal literatures. This can lead to considerable confusion in understanding principles of the location of taxation of corporate profit, which is worth briefly elaborating upon.

Under the *residence principle*, countries tax residents – including corporations – on their worldwide income, regardless of where it is earned. However this deceptively simple definition hides significant differences in concept. Theoretical economics literature tends to regard residence as the place where the owner of the income stream resides; it also typically assumes – often implicitly – that individuals invest only domestically, and thus a company is owned by domestic residents, with no distinction in location between the shareholders' residence and the company's residence. In much of the theoretical literature, the place of residence is therefore taken as fixed, although of course, this correspondence need not hold in practice, and a parent company of a multinational may be owned by shareholders worldwide. In this case, the residence of the parent company would not reflect the residence of its owners, and instead the location of the parent company is as mobile as the location of any other part of the company, since it is not constrained by the residence of its owners. By contrast, for legal purposes residence is assessed individually as regards every independent legal person. Thus the parent company and all its subsidiaries – as separate legal entities – may be deemed to be resident in the country in which they are located, i.e. the place of incorporation and/or the place of management.

Under the *source principle* a country may tax income having its source in that country, regardless of the residence of the taxpayer. The economics literature regards the source of the corporation's profit as the place where the profit is earned – separately from the place where the owner of the profit resides. But of course, where the profit is earned is generally not well defined, and thus source is mainly a term that can be distinguished from residence – where the person with the rights to receive the profit is located. By contrast again, source has a technical meaning for legal purposes, identifying the location in which profit is generated when there is no legal residence – typically when the company has a permanent establishment, but no legal residence in that location.

Most countries do not model their tax systems exclusively in either source or residence, but rather have a hybrid system. Very broadly, the OECD model convention assigns tax rights on active business income to the source country, and on passive income to the residence country. But this is a source of dispute: it is generally believed that traditionally developed – capital exporting – countries tend to place heavier emphasis on the residence principle; whilst capital importing countries in general place

more emphasis on the source principle.<sup>13</sup> This is reflected in the view that, while the UN model convention, developed in the 1980s, places a stronger emphasis on source-based taxation. These comments reflect the economic sense of these terms, not the legal sense.

Traditionally the view of residence-based taxation – again in the economic sense – as superior to source-based taxation has been a central tenet of the normative theory of international taxation.<sup>14</sup> This is because if the place of residence is fixed (because the owners are immobile), then a tax based on residence will not affect the location of activities; the tax system will exhibit capital export neutrality, CEN.<sup>15</sup> However, there is no merit in basing the allocation of profit on the legal interpretation of residence, since that form of residence is not fixed; doing so will not ensure CEN. This comment also applies *mutatis mutandis* to basing the allocation of profit on the residence of the parent company; this residence is not fixed, and doing so will not generate CEN, since the parent company itself may move to a lower-taxed country.<sup>16</sup> More recently, the economics literature has considered whether differences in taxes between countries can give rise to distortions to the ownership of companies – another aspect of the more general notion of production efficiency; the absence of such distortion is known as capital ownership neutrality, CON.<sup>17</sup> The precise requirements for the international tax system to generate CON are still in dispute:<sup>18</sup> although it has been claimed that source-based taxation in the economic sense would be required, this is only true in very specific circumstances.

In practice, the international tax system is now closer to source-based taxation in the traditional economic sense. The US is the only major country that still attempts to tax the worldwide income of its resident companies; and even then it does so only on repatriation and with a partial credit for taxes already paid – with the result that huge funds are held offshore to avoid the US tax on repatriation. Within the EU, secondary tax legislation too leans towards source-based taxation in the traditional economic sense, since most withholding taxes on flows of dividends interest and royalties

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<sup>13</sup> For an overview of the rationale for adopting either residence or source-based taxation see P. Musgrave, "Consumption Tax Proposals in an International Setting" (2000-2001) *Tax Law Review* 54, 77-100, at 77 et seq.

<sup>14</sup> See M. Keen and D. Wildason, "Pareto-Efficient International Taxation" (2004) *American Economic Review* 94(1), 259-275.

<sup>15</sup> A term originally introduced by R. Musgrave in "Criteria for foreign tax credit" (1959) *Taxation of Operation Abroad*, The Tax Institute, Princeton.

<sup>16</sup> See J. Voget, "Headquarter Relocations and International Taxation" (2011) *Journal of Public Economics* 95.

<sup>17</sup> See M. Desai and J. Hines, "Evaluating International Tax Reform" (2003) *National Tax Journal* 56(3), 487-502; and M. Desai and J. Hines, "Old Rules and New Realities: Corporate Tax Policy in a Global Setting" (2004) *National Tax Journal* 57(4), 937-960.

<sup>18</sup> See M.P. Devereux, C. Fuest and B. Lockwood "The Taxation of Foreign Profits: a Unified View" (2013) *Oxford University Centre for Business Taxation Working Paper* 13/3.



within the EU are no longer permitted,<sup>19</sup> although the position of the Court of Justice of the European Union (CJEU) is less clear or consistent.<sup>20</sup>

However, this leaves to one side the significant difficulties in defining the economic notion of the source of profit. There are two distinct problems with basing the international tax system on this concept. The first is that differences in tax rates between countries distort the location of productive activity. It is possible to try to balance this distortion against the distortions created by the lack of ownership neutrality, yet global production efficiency cannot be achieved by residence or source-based taxation unless they are fully harmonised.<sup>21</sup> More fundamentally, however, as argued above, there is usually no single source of profit: profits arise from many locations as a multinational takes advantage of local conditions to maximise its worldwide profit. The absence of a clear concept of where profit is generated means that ultimately the traditional economic concept of source is of little value. The current international tax allocation rules have been characterised as a flawed miracle.<sup>22</sup> We agree that they are flawed; we are less persuaded that they are a miracle.

It is clear, therefore, that neither of the traditional economic notions of residence and source serve any longer as an adequate basis for the allocation of rights to tax the profits of multinational companies. Such a conclusion gives rise to the question of whether there is an alternative model. Is it possible to conceive of a model for allocation of corporate taxing rights, which would meet the two criteria outlined in the introduction: which would minimise distortions, whilst still satisfying the principle of jurisdiction to tax, from both a substantive, as well as an enforcement perspective?

## **B. Destination-Based Taxation**

Proposals for a paradigm shift in allocation of corporate taxing rights have emerged in the early 2000s. In 2000, Avi-Yonah proposed that the OECD should adopt a regime that taxed multinationals as an initial matter in the country of consumption of the goods or services provided by them.<sup>23</sup> In

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<sup>19</sup> The Parent-Subsidiary Directive, Council Directive 90/435/EEC of 23 July 1990 OJ L225, 20/08/1990, 6; the Interest and Royalties Directive, Council Directive 2003/49/EC of 3 June 2003, OJ L157, 26/06/2003, 49; and the Savings Tax Directive, Council Directive 2003/48/EC of 3 June 2003 OJ L157, 26/06/2003, 38-48.

<sup>20</sup> Defending that source-based taxation would be consistent with CJEU jurisprudence, see 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), 430-452. For a contrary view see B.J.M. Terra and P.J. Wattel, *European Tax Law* (The Hague: Kluwer Law International, Fourth Edition, 2005), at 80-83. For an comprehensive analysis of why the Court is in a "labyrinth of impossibility", see M. Graetz and A. Warren, "Income Tax Discrimination and the Political and Economic Integration of Europe" (2005-2006) *Yale Law Journal* 115, 1186-1255.

<sup>21</sup> M. Devereux, "Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations" (2008) *Oxford Review of Economic Policy* 24(4), 698-719.

<sup>22</sup> See R. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification" (1996) *Texas Law Review* 74, 1301-1359, at 1303-1304.

<sup>23</sup> R. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) *Harvard Law Review* 113(7), 1573-1676, at 1670-1671.

2002, Bond and Devereux proposed a cash flow tax on a destination basis. This proposal was further developed in a series of papers published in the following years, where the properties of a destination-based corporate tax were explored further, confirming that – as opposed to residence or source-based corporate taxes – such a tax would not create distortions to any margins of business decisions, namely choice between discrete options, choice of scale of investment, choice of form of income, and choice of source of finance. The destination-based tax would still be a tax on corporate profits, but would work similarly to a VAT: the key difference between the two being the treatment of labour, which would be regarded as deductible business costs under the proposed destination-based tax, but are not so under a VAT.<sup>24</sup>

These studies show that it is indeed possible to theoretically conceive of an alternative model for allocation of corporate taxing rights, which is neither based on residence or source, but rather on destination.<sup>25</sup> Moreover, it is argued that this alternative model would in principle significantly minimise economic distortions, when compared to existing models – indeed support for such a paradigm shift has been gathering momentum.<sup>26</sup> The subsequent question therefore is whether and how that theoretical model would work in practice, allowing us to identify a location of taxation which creates minimum economic distortions, and had a substantive and enforcement jurisdiction to tax.

### III. DESIGNING AND IMPLEMENTING A DESTINATION-BASED CORPORATE TAX

As noted above, whilst our proposals for designing and implementing a destination-based corporation tax draw heavily on the experiences of VAT, the proposals set out below do not blindly follow VAT rules as implemented in Europe or elsewhere. On this regard, the first point of departure from normal VAT rules is particularly significant. The OECD defines the destination principle as the “principle whereby internationally traded services and intangibles should be subject to VAT in their

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<sup>24</sup> 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), 837-893; A. Auerbach and M. Devereux, “Consumption and Cash-Flow Taxes in an International Setting” (2012) *Oxford University Centre for Business Taxation Working Paper Series*, WP 12/14; and M. Devereux, “Issues in the Design of Taxes on Corporate Profit” (2012) *National Tax Journal* 65(3), 709-730.

<sup>25</sup> It is worth noting that proposals for a destination-based corporate tax do not necessarily require a new allocation of taxing rights paradigm, and under the proposed economic model distortions would still be eliminated by applying the corporate tax rate of the country of destination. From a legal perspective, however, it is difficult to conceive how such result could be achieved without altering allocation of taxing rights rules.

<sup>26</sup> A. Fernandes de Oliveira, “A Residência, a Fonte e a Tributação” (2007) *Ciência e Técnica Fiscal*, 219-299; and W. Barker, “A Common Sense Corporate Tax: The Case for a Destination-Based, Cash-Flow Tax on Corporations” (2012) *Catholic University Law Review* 61(4).

jurisdiction of consumption”.<sup>27</sup> This definition is clearly linked to the notion that VAT is intended to be a tax on consumption, and hence levied in the jurisdiction in which the consumption takes place – destination is a proxy for consumption. For the purposes of the destination-based tax, destination is intended to be a place of relative immobility – we therefore define it to be the place of residence of the customer. In this sense it is not intended as a proxy for consumption. The criteria for determining whether a destination-based corporate tax is an appropriate alternative to the current international tax rules is not therefore linked to consumption, but rather to broad aims of an international system of taxing corporate profit.

In this regard, it must be noted that it is not necessary that revenue be allocated to the country in which the sale to the customer takes place. To meet the requirements of criterion 1, it is not necessary to set out who should actually receive the tax revenue. In practical terms, mere application of criterion 1 could point in two directions. Indeed it is possible that the revenue is not allocated to the country of destination. This would be much closer to the existing system, and therefore perhaps easier to move towards; the key difference from the existing system would be that the tax rate charged by country, which retains the right to tax under the current international system, would depend on where the goods were sold. Since – in the absence of international constraints – countries are free to choose on the applicable corporate tax rate this move would have limited legal consequences. This would deem discussion of the jurisdiction to tax (criterion 2) unnecessary, since the current international allocation of taxing rights system would remain unchanged. On the other hand, having made the case politically for the place of tax to be in the location of the sale to the third party, it would be difficult to allow the revenue to end up in a different country. In this case criterion 2 needs to be considered, since this move would imply a paradigm shift as regards the current international allocation of taxing rights system: from allocation on the basis of residence or source, to allocation on the basis of destination.

This last situation is the main subject of this paper. At first sight, it may seem straightforward to implement a tax which is very similar to VAT. Indeed, the tax base proposed for a destination-based tax is in effect equal to the tax base for VAT except for the treatment of labour costs – which are deductible the proposed, but not for VAT. There are three reasons why simply assuming the tax could be levied like VAT is not sufficient. First, the treatment of labour costs does raise some special issues: for example, a company that exports all of its produce would in principle have a negative tax base in its country of production (though an offsetting taxable income in the country of sales); but that raises the issue of how to deal with such a situation. Second, it is not proposed that the destination-based tax is levied on the basis of the invoice-credit method used almost universally in

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<sup>27</sup> OECD (2013), as above, p. 3.

VAT, but rather that, like existing corporation taxes, it is based on an annual assessment of the tax base in each jurisdiction. Third, existing VAT rules for cross-border trade are far from straightforward, and indeed, *a priori* it is not clear that VAT rules meet the requirements of criterion 2, as discussed below.

The subsequent question therefore is whether the proposed destination-based corporate tax satisfies criterion 2 for determining the place of taxation, namely jurisdiction to tax; in essence, whether this model is workable from a practical, as well as conceptual, perspective. Indeed, whether the tax is achievable in practice is essentially dependent on whether the country of destination – i.e. the country to where the sale of goods or services is being made – has the jurisdiction to tax the corporate profits arising from those sales. Jurisdiction to tax is a term often used, but seldom theorised; a particular useful theoretical framework is that proposed by Hellerstein, which distinguishes between substantive jurisdiction and enforcement jurisdiction: substantive jurisdiction is the power of the state to impose tax, whilst enforcement jurisdiction is the power of the state to collect the tax.<sup>28</sup> Whilst not usually recognised, there is indeed a discrete distinction between these two aspects of tax jurisdiction: a conceptual (or substantive) aspect, which encompasses the 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; and a practical (or enforcement) aspect, which focus on the ability to tax, i.e. whether the country has effective legal and implementing means of collecting the proposed tax.

#### **A. Substantive Tax Jurisdiction**

Does the destination-based corporate tax have substantive tax jurisdiction? That is, is it legitimate for the country of destination to tax the corporate profits arising from sales in its territory? There is clearly a connection between what is being taxed and the country imposing the tax. If sales are being made in a country, then arguably that country is the origin of the income: it is from sales that profits are generated, without sales there would be no income to tax.<sup>29</sup> The recent tax scandals involving companies like Starbucks, or Amazon, highlight the significance of this connection: they have been precisely criticised by the UK media,<sup>30</sup> and by the UK Public Accounts Committee,<sup>31</sup> for not paying tax where they are making sales. But sales are not at present the basis for the corporation

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<sup>28</sup> W. Hellerstein, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" (2003) *Georgia Law Review*, 1-39.

<sup>29</sup> A. Fernandes de Oliveira, n. (...) above.

<sup>30</sup> See for example T. Bergin, "Special Report: How Starbucks avoids UK Tax", *Reuters*, 15 October 2012; BBC, "Starbucks, Google and Amazon grilled over tax avoidance", 12 November 2012; R. Syal and P. Wintour, "MPs attack Amazon, Google and Starbucks over tax avoidance", *The Guardian*, 3 December 2012.

<sup>31</sup> Public Accounts Committee, *19<sup>th</sup> Report – HM Revenue and Customs: Annual Report and Accounts*, 28 November 2012.

tax.<sup>32</sup> Therefore, whilst their actions are being labelled as tax avoidance, in reality the reference of the Public Accounts Committee to “companies which generate significant income in the UK but pay little or no tax” is a call for a paradigm shift in the international allocation of corporate taxing rights: corporate income tax should be paid where the income is perceived to have been generated, i.e. where sales are made.

However, whether this connection is sufficiently strong to legitimise jurisdiction to tax corporate income is a matter which should be assessed, not solely in the context of current public views on the issue, but also in light of the broader theoretical aspects of tax jurisdiction. Traditionally the rationale for establishing jurisdiction to tax was based on the benefits principle, according to which individuals and corporations should contribute to government according to the benefits they receive from it.<sup>33</sup> The principle has been subject to various formulations over the years, and has been heavily criticised for not standing-up to close inspection, despite its superficial logic.<sup>34</sup> Yet, even if one accepts the validity of the benefits principle as a basis for jurisdiction to tax, the arguments used to justify source-based corporate taxation under that principle can be applied *mutatis mutandis* to destination-based corporate taxation.<sup>35</sup> The idea that the country where the income is generated should be compensated can also apply to legitimise destination-based taxation if one takes the origin of the income to be the place where profits are made.

More recently fairness has emerged as an issue for establishing jurisdiction to tax.<sup>36</sup> Fairness has of course various dimensions, but two of which are particularly relevant for tax jurisdiction: the first is the notion of entitlement; the second is the notion of inter-nation equity. The notion of entitlement was originally proposed by Musgrave to legitimise source-based taxation but – similarly to the benefits principle – the arguments presented can be equally applied to legitimise destination-based taxation: countries should be entitled to tax income originating within their borders, because it is the

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<sup>32</sup> M. Devereux, J. Freedman and J. Vella, *Tax Avoidance: Paper 1*, Oxford University Centre for Business Taxation, Review Commissioned by the National Audit Office into the Disclosure of Tax Avoidance Schemes Regime, November 2012.

<sup>33</sup> Another traditional rationale for legitimising jurisdiction to tax was the sacrifice principle, according to which taxes are viewed as a sacrifice owed to the country; however this principle is not generally supported today, see K. Vogel, “Worldwide vs. Source Taxation of Income – A Review and Re-Evaluation of Arguments (Part III)” (1998) *Intertax* 11, 393, at 394-395.

<sup>34</sup> See R. Palmer, “Towards Unilateral Coherence in Determining Jurisdiction to Tax Income” (1989) *Harvard International Law Journal* 30(1), 1-63, at 24 *et seq.* See also L. Murphy and T. Nagel, *The Myth of Ownership – Taxes and Justice* (Oxford University Press, 2002), at 16-19; and J.M. Dodge, “Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles” (2004-2005) *Tax Law Review* 58, 399-462.

<sup>35</sup> See arguments and literature cited in D. Pinto, n. (...) above, at 18 *et seq.*

<sup>36</sup> R. Musgrave and P. Musgrave, *Public Finance in Theory and Practice*, 4<sup>th</sup> ed. (McGraw-Hill, 1984).

“place of income-originating activity”,<sup>37</sup> an entitlement which stems from the principle of territoriality under international law;<sup>38</sup> moreover countries should be entitled to tax income originating within their borders, since the countries where consumers reside provide services that are complementary to the consumption of their residents.<sup>39</sup>

Under the principle of inter-nation equity each country should be allocated an equitable share of the tax base from cross-border transactions. Discussions over the possibility of using tax systems as a means of distributing income globally started with the work of the Musgraves, who introduced the concept in 1972.<sup>40</sup> Several different approaches to the conceptualisation of inter-nation equity have been proposed.<sup>41</sup> However, few have elaborated on how the inter-nation equity criterion should apply in practice, probably because the concept is too vague to provide specific guidance on how to allocate taxing powers.<sup>42</sup>

It is likely – though not certain – that a substantial tax reform to a destination-based tax would produce losers as well as gainers in terms of tax revenue. (It is not certain, for several reasons; if there is less tax avoidance, then the total tax base will increase; further, since governments would not face competitive pressure under a destination-based tax, they would be able to raise their tax rates). It is not clear that the reform would be unfavourable to developing countries, for example. Indeed, Several developing countries already have destination-based taxation, namely for services. All DTTs signed by India since 1957, the 8<sup>th</sup> largest services importer in the world, include a source rule as regards services – very broadly defined – which taxes where payer of the service is located; essentially a destination-based tax rule, which uses the costumer location as proxy. Brazil excludes significant portion of services from the scope of their DTTs,<sup>43</sup> subjecting them instead to a national allocation rule, which too uses payer’s location as proxy for source; similar rules apply in other Latin-American (LATAM) countries, such as Argentina, Mexico, and Peru. Moreover, during recent negotiations for the new UN model convention, consideration is being given to the possibility of inclusion of a similar rule to those in India’s DTTs.

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<sup>37</sup> R. Musgrave and P. Musgrave, “Inter-Nation Equity” in *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (University of Toronto Press, 1972), at 71.

<sup>38</sup> N. Kaufman, “Fairness and the Taxation of International Income” (1998) *Law and Policy in International Business* 29, 145, at 192.

<sup>39</sup> P. Musgrave, “Interjurisdictional Coordination of Taxes on Capital Income” in S. Cnossen (ed.), *Tax Coordination in the European Community* (Springer, 1987), at 198.

<sup>40</sup> R. Musgrave and P. Musgrave, n. (...) above.

<sup>41</sup> For a comprehensive analysis of the literature see K. Brooks, “Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Value” in R. Krever *et al* (eds.), *Tax Reform in the 21<sup>st</sup> Century: Essays in Memory of Richard Musgrave* (Kluwer Law International, 2009), 471-498.

<sup>42</sup> T. Edgar, “Corporate Income Coordination as a Response to International Tax Competition and International Tax Arbitrage” (2003) *Canadian Tax Journal* 51, 1079, at 1154.

<sup>43</sup> Even though Brazil does not have an extensive convention network, see IFA 2012 Report.

It should also be noted that moving towards a destination basis for a general corporation tax does not preclude special additional taxes, especially on natural resources.

## **B. Tax Base**

Three elements of the proposed tax base are worthy of discussion. First, as is well-known, a cash-flow tax is in effect a tax on economic rent – that profit over and above the minimum required rate of return. This differs from the conventional form of income tax. However, elements of cash-flow taxation have been used in many countries and on many occasions. Taxing only part of the conventional measure of profit, or the return to investment, does not seem to raise any problems of substantive tax jurisdiction.

Second, the R+F base treats financial flows rather differently from conventional taxes. Essentially, new borrowing and interest received are added to the tax base, while lending and repayment of borrowing and interest payments are all deductible. The net effect of this is to tax economic rent earned by lenders (who receive a higher a rate of interest than they pay). This means that – unlike current practice for VAT - financial companies can be included in the tax base. Again, no specific issues of substantive tax jurisdiction seem to be raised by including financial flows in the tax base in this manner.

A third issue is the scope of the tax. As with VAT, the procedures work best if all businesses are registered for the tax. However, that is problematic if the tax is intended to apply only to incorporated businesses. A more ambitious agenda would see this tax applying to all businesses, whether incorporated or not, just as VAT is. That would run into the possibility of double taxation, however, since the income of unincorporated businesses may also be subject to personal income tax. This issue requires more consideration; however a starting point is that the destination-based tax could be applied to all businesses (subject to a threshold – indeed the VAT threshold could be used), but that it would be creditable against personal income tax.

## **C. Enforcement Tax Jurisdiction**

Does the destination-based corporate tax have enforcement tax jurisdiction? I.e. does the country of destination have the effective legal and implementing means of collecting tax on corporate profits arising from sales in their territories? The proposed destination-based corporate tax is broadly

similar in outline to a normal VAT, also levied under the destination principle;<sup>44</sup> indeed adherence to the destination principle is singled-out as one of the key areas in which all VATs are fundamentally similar.<sup>45</sup> However, the allocation of taxing rights rules under a destination-based VAT – often known as place of supply or place of taxation rules – are far from unproblematic.

### 1. Identifying Destination

Identifying the country of destination is not as simple as it might appear, particularly as regards services. VAT systems usually really on legal proxies to identify destination – itself a legal proxy for consumption – but how many proxies are necessary, or how complex the proxy chain is, will depend from system to system. In general, all VAT systems use tangible and intangible proxies: tangible proxies being those that make reference to physical objects, and intangible proxies relate to features of the persons involved in the transaction.<sup>46</sup>

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

The European VAT system is particularly complex, and determining the place of taxation of any specific transaction will depend on various questions: whether the supply made involved goods or services; the identity of the acquirer, in particular whether he is a VAT registered person or not; the

<sup>44</sup> R. Millar, “Echoes of source and residence in VAT jurisdictional rules” in M. Lang *et al* (eds.), *Value Added Tax and Direct Taxation – Similarities and Differences* (Amsterdam: IBFD, 2009). For a comparative analysis of origin vs. destination principles, and the reason behind the “weak” presumption in favour of destination see M. Keen and W. Hellerstein, “Interjurisdictional Issues in the Design of a VAT” (2009-2010) *Tax Law Review* 63, 359; see also B. Lockwood, “Commodity Tax Competition Under Destination and Origin Principles” (1993) *Journal of Public Economics* 52, 141.

<sup>45</sup> R. Bird and P.P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press, 2007), at 15.

<sup>46</sup> This useful distinction is made by R. Millar, n. (...) above.



timing of the supply; the location of the supply; and the nature of the goods or services supplied.<sup>47</sup> However, all VAT systems use a mixture of tangible and intangible proxies, often in an interlinked manner, which gives rise to proxy chains. Naturally the more complex the proxy chain is, and/or link between different proxies are, the more difficulties they will give rise to: increased compliance costs, increased litigation, opportunities for fraud and avoidance, and acting as deterrent for cross-border transactions, particularly for SMEs.

The use of proxies is a universal feature of VAT systems, recommended by the OECD as the most practical and appropriate way in which to establish destination – and thus consumption.<sup>48</sup> On this regard the rationale applies *mutatis mutandis* to a destination-based corporate tax: such a tax would be equally dependent on use of proxies to establish the place/country of destination.<sup>49</sup> However, use of complex proxy chains or interlinked proxies should be avoided as far as possible, and allocation rules made as simple as feasible, in order to avoid extra difficulties.

Establishing destination as regards cross-border trade in goods is relatively straightforward, and whilst many VAT systems make use of various proxies for different goods, using one single proxy will achieve destination in most cases with minimal complexity: the customer location, i.e. the location, residence, or place of business of the customer, the person to whom the seller has a contractual legal obligation to supply the goods. Using this proxy alone will often not lead to taxation at the place/country of consumption, for example when an intermediary buys the goods, which are then to be consumed by someone else, which is why other proxies are often used in conjunction, such as the location of the goods, or the place of effective use or enjoyment. This however is not a consideration for a destination-based corporate tax, since destination is not proxy for consumption, but the aim in itself. It is possible that in a few cases using only the customer location proxy might not lead to taxation at the place/country of destination. However, for the sake of simplicity, and as long as this does not create administrative difficulties or opportunities for avoidance or fraud – see below – using a single proxy for identifying destination in all cross-border sales of goods in both business-to-business transactions (B2B) and business-to-consumer transactions (B2C) avoids many of the problems often witness as regards VAT systems.

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<sup>47</sup> For details of the European VAT place of supply rules and the proxies chains applied therein see R. de la Feria, n. (...) above, at 970 et seq.

<sup>48</sup> OECD, *Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-Commerce – Guidelines on the Place of Consumption*, 2010.

<sup>49</sup> The inevitability of having to use proxies in this context has been acknowledged by R. Avi-Yonah, n. (...) above, at 1671-1672.

Traditionally it was said that implementing the destination principle as regards cross-border trade in services was more complicated, and that the challenge for VAT design was how to identify – or provide mechanisms for identifying – the destination of services in the absence of physical flows.<sup>50</sup> For this reason, in the last few years the OECD has issued several guidelines on how to apply the destination principle to services, culminating in a version released in February 2013.<sup>51</sup> Despite the additional difficulties, we propose that the same proxy is adopted for identifying destination in all cross-border supplies of services as suggested for sales of goods, i.e. the customer location proxy – with a few adjustments.<sup>52</sup> In B2B transactions this proxy can be easily applied by reference to the business agreement, but it might be problematic where the customer has establishments in more than one jurisdiction, and the services are used by one or more establishments of those establishments, under an internal recharge arrangement. The OECD proposes that in these cases taxing rights should be allocated on the basis of two-step proxies' chain: first step would be the application of the customer location proxy; the second step would be consumer location proxy, i.e. the location of the establishment using the service. Using the consumer location proxy makes sense as regards a consumption tax, but less so as regards a destination-based corporation tax. Ignoring the internal recharges however would not respect the destination principle – it is therefore proposed that internal recharges should be deemed to be transactions which trigger the application of the customer location proxy. As regards B2C transactions in cross-border services, they are perceived as creating particular difficulties in terms of administrative obligations since applying the customer location proxy would often result in multiple-registration, i.e. a requirement to register for VAT purposes in every jurisdiction where sales are carried out.<sup>53</sup> If however these administrative obligations can be overcome – see below – then the customer location could work as a good proxy for establishing destination, without any need to use further proxies.

Notwithstanding the above, it is proposed that in exceptional circumstances the proxy used for determining the place / country of taxation varies from the customer location proxy, particularly as regards B2C transactions, namely where that rule would not lead to an appropriate result or be too burdensome. This will be particularly the case where the supply of services- or the supply of goods where no physical borders are present, such as in intra-EU supplies – require the physical presence of both the supplier and the customer in some way, and the service or

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<sup>50</sup> M. Keen and W. Hellerstein, n. (...) above.

<sup>51</sup> OECD, *OECD International VAT/GST Guidelines*, Draft Consolidated Version, February 2013.

<sup>52</sup> This is also the recommendation of the OECD as the main rule for B2B transactions, see *ibid.*

<sup>53</sup> The OECD does not provide specific guidelines for B2C transactions in cross-border services, listing them under the heading “future work”, see *ibid.*

goods are supplied at a readily identifiable location, such as restaurant services and right to access events (concerts, sports games, fairs and exhibitions), or cross-border shopping. Making an exception to the main proxy for these cases makes sense from both a VAT and a destination-based corporate tax perspective, since in these cases destination is readily identifiable as the place where the supply of services / goods is carried out, and applying the customer location proxy could potentially lead to distortive results and fraud, as well as being burdensome for suppliers. It is therefore proposed that in these exceptional circumstances a tangible proxy is used: either the place of performance as regards services, i.e. the place where the service is effectively carried out; or the place of location as regards goods.

Outside the scope of these exceptions is therefore e-commerce, which we propose will still be subject to the customer location proxy. Applying the place of location proxy to cross-border shopping, whilst still applying the customer location proxy to distance sales – and in particular to e-commerce – will unavoidably result in an economic distortion, insofar as the profits arising from the sale of similar goods may be subject to different rates of corporate income tax. However, since studies on cross-border shopping within the EU seem to indicate that the overall number is relatively small – even in border regions – the distortion should not be significant.<sup>54</sup>

## 2. Administrative Obligations

One of the traditional principles of international tax law is the so-called revenue rule – also known as the *Government of India* principle –<sup>55</sup> whereby, absent agreement or limited exceptions, countries will not assist in collecting taxes for another country. Over the last decade, however, the world has witnessed the progressive demise of this principle insofar as income taxes are concerned, with increased cooperation between tax authorities spurred by EU legislation on mutual assistance, and various OECD initiatives on exchange of information. This demise has largely resulted from a drive to combat tax evasion, but it could be much wider: it could result in the expansion of enforcement jurisdiction to tax, since taxes can be collected by one country on behalf of another country.<sup>56</sup>

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<sup>54</sup> PwC, *VAT and Excise Duties: Changes in Cross-Border Purchasing Patterns Following the Abolition of Fiscal Frontiers on 1 January 1993*, Final Report prepared for the European Commission, DG XXI/C-3, August 1994; J. Ratzinger, *Retail Strategies to Benefit from Indirect Tax Differences*, Study prepared for the European Commission, March 1996; and European Commission, *Report from the Commission to the Council and to the European Parliament in accordance with Article 12(4) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: Uniform basis of assessment*, COM(97) 559 final, 13 November 1997.

<sup>55</sup> After the famous UK case *Government of India v Taylor* [1955] AC 491.

<sup>56</sup> See P. Baker n. (...) above.

Insofar as VAT is concerned, the demise of the revenue rule and (implicit) proposals for its abolition within the EU started decades earlier. In 1987 the European Commission presented a series of proposals aimed at treating intra-EU supplies of goods and services in a similar manner as internal supplies. Thus, instead of zero-rating supplies to another Member State, the VAT rate applicable in the Member State of departure would be charged, and the foreign VAT could simply be deducted by the trader in the Member State of destination, in the same way as the national input tax, i.e. through its VAT return.<sup>57</sup> In order to minimise the impact of this measure on Member States' revenues, the European Commission proposed the establishment of a clearing house system to ensure that VAT collected in the exporting country and deducted in the country of import could be credited to the latter.<sup>58</sup> These proposals, which the Commission misleadingly referred as collectively representing a switch to the origin principle,<sup>59</sup> were widely regarded as too ambitious.<sup>60</sup> By 1989 it was clear that the Council would fail to reach an agreement and the Commission was forced to temporarily abandon the proposals. The switch to the so-called origin principle remained a long-term objective of the Commission, however, until it was formally abandoned in 2012.<sup>61</sup> By then the European Commission already had an alternative proposal, which it too would imply the demise of the revenue rule within the EU for VAT purposes: the one-stop-shop (OSS).

In 2004 the Commission presented a legislative proposal for a new compliance scheme for businesses operating in more than one Member State, which it designated of OSS. Designed to avoid the need for multiple registrations, the scheme would allow a trader to register in only one Member State, making its B2C supplies using a single VAT number; tax would be charged at the rate of the country of destination, and the revenue collected by the country where the trader was established, but sent to the country of destination. The proposal received favourable feedback from traders and other stakeholders,<sup>62</sup> but it failed to gather the political support for unanimous approval at the Council. The big victory for the Commission came a few years later with the approval of the

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<sup>57</sup> European Commission, *Proposal for a Council Directive completing and amending Directive 77/388/EEC – Removal of fiscal frontiers*, COM(87) 322 final, 21 August 1987.

<sup>58</sup> European Commission, *Completing the internal market – the introduction of a VAT clearing mechanism for intra-Community sales*, Working document from the Commission, COM(87) 323, 5 August 1987.

<sup>59</sup> Whilst from the perspective of traders the system could be perceived as origin-based taxation, the final outcome is equivalent to that of destination-based taxation, see B. Lockwood *et al*, "On the European Union VAT Proposals: The Superiority of Origin over Destination Taxation" (1995) *Fiscal Studies* 16(1), 1–17, at 5.

<sup>60</sup> See A.J. Easson, "The Elimination of Fiscal Frontiers", in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellschaft, 1988), 241–260.

<sup>61</sup> See European Commission, *Green Paper on the Future of VAT – Towards a simpler, more robust and efficient VAT system*, COM(2010) 695 final, December 1, 2010; and R. de la Feria, "The 2011 Communication on the Future of VAT: Harnessing the economic crisis for EU VAT reform" (2012) *British Tax Review* 2, 119–133.

<sup>62</sup> European Commission, *VAT: public consultation on One-Stop-Shop project*, Press release IP/04/654, 18 May 2004; and European Commission, *Consultation Paper: Simplifying VAT obligations – the one-stop system*, TAXUD/590/2004, March 2004.

so-called VAT package in 2008. Whilst the package included many alterations to the EU VAT rules, it crucially included rules for what was later designated as the mini-one-stop-shop (MOSS) solely for electronically supplied services. These rules are due to come into force on the January 1<sup>st</sup>, 2015, and the significant legislation has been approved in the interim period regarding the implementation of the MOSS, particularly as regards administrative arrangements.<sup>63</sup>

The introduction of the MOSS has been criticised for placing extra compliance burdens on suppliers of electronic services, since the onus is placed on them to check the status of the acquirer – business or final consumer – as well as their location.<sup>64</sup> This would be relatively straightforward on B2B transactions where the acquirer has to provide a VAT number; much less so as regards the B2C transactions. The European Commission has recently proposed that the location of the customer is identified on the basis of the IP address of the acquirer of the services; however, it has been pointed out that IP addresses are easily manipulated. A more reliable form of detecting the location of the customer would be his/her residence, which can be identified on the basis of the credit card used for paying the transaction – of course this too can be manipulated, but the scope for fraud is much smaller. The proposal is currently being discussed by the Council, and the European Commission has formally expressed its wish to ensure that the MOSS is successful, with a view to expanding its scope to other areas of trade.<sup>65</sup>

In light of the already ongoing demise of the revenue rule for income tax purposes, as well the apparent success of the MOSS within the VAT area, it is proposed that the destination-based tax is also collected on the basis of a OSS approach, under which a given country (A) may collect the tax on behalf of another country (B). That is, a multinational may produce a good in A, and sell it to a consumer in B. In that case, it is possible for the tax authority in A to require the company to declare where it sells its output (ie. B), for the tax authority in A to collect the appropriate amount of tax at B's tax rate, and then pass the revenue to country B. The tax authorities of both countries could then do an aggregate reconciliation across all transactions in a given period. Under such a system, the *enforcement* jurisdiction is *de facto* delegated by country B on country A, whilst the *substantive* jurisdiction is kept by country B, which ends up receiving the tax revenue.

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<sup>63</sup> Council Regulation (EU) No. 967/2012 of 9 October 2012 amending Implementing Regulation (EU) No. 282/2011 as regards the special schemes for non-established taxable persons supplying telecommunications services, broadcasting services or electronic services to non-taxable persons; and Commission Implementing Regulation (EU) No. 815/2012 of 13 September 2012 laying down detailed rules for the application of Council Regulation (EU) No. 904/2010 as regards special schemes for non-established taxable persons supplying telecommunications, broadcasting or electronic services to non-taxable persons services to non-taxable persons.

<sup>64</sup> See M. Lamensch, "Unsuitable EU VAT Place of Supply Rules for Electronic Services – Proposal for an Alternative Approach" (2012) *World Tax Journal*, 77-90.

<sup>65</sup> European Commission n. (...) above.

One advantage of the OSS approach relates to the treatment of labour costs, which are the essential difference between the tax base of the destination-based corporation tax and VAT. In its pure form, a country producing in A and exporting all of its output to B would have a taxable loss in A and taxable income in B; it would then receive a rebate in A and pay tax in B. This tends not to happen with VAT since labour costs are not deductible and so the chance of having negative value added in A is low. But deducting labour costs this scenario could be common. It creates a problem to the extent that the government in A is not willing to pay a rebate; indeed if there is a chance of fraudulent activity it would be wise to be cautious in doing so.

However, the OSS approach significantly reduces this problem. That is because the tax levied in A will include a charge at B's tax rate on the export to B. The company resident in A would then face a tax charge in A similar to under a normal corporation tax system, with the exception that the tax rate applied to exports would be at B's rate, rather than A's rate. In most cases, then, the overall taxable profit in A would be positive and the need for a rebate would not arise.

Of course, we expect A to make a payment to B to reflect the tax collected on B's behalf. But this can be done at an aggregate level, netting off any tax collected in B on exports to A. Indeed, more generally, we envisage a clearing house in which many countries pool this revenue with only net adjustments having to be made. The adjustments for a country with balanced trade within a given period would net out to zero.

These issues raise the question of the allocation of costs of collection. It would be reasonable for the collecting country to charge a fee for collection, which may be a small proportion of total revenue collected. These fees would also be netted out in a final settlement between countries. It might also be necessary to implement a de minimis rule where collection costs outweigh the revenue.

Another issue is that of mispricing of within-firm transactions. This is clearly an issue with the normal form of corporation tax, since by under- or over-pricing a sale to another part of the multinational group in another country, taxable profit can be shifted to a country with a lower tax rate. However, this problem does not arise with the destination-based tax as long as trades are undertaken between entities that are subject to this form of tax. To see this, consider the possibility of routing an export from A to B via a tax haven, H, which has a zero tax rate. Assume the OSS system is in place, and that H is part of that system. Country A should tax the export at rate zero since it is destined for H. Country H should in principle tax the import, although again at rate zero. But it will then tax the export to B at B's tax rate; and it should pay the revenue collected to B in accordance with the destination principle. This is exactly the same outcome as if the export had not been routed through the tax haven. Further, if the buyer in B is the final consumer, the price at which the sale in

B takes place is determined on markets as normal. The price of the transaction from A to H does not affect the final tax liability, and so is irrelevant. This result continues to hold under other administrative arrangements as long as the tax is ultimately based in the location of the final customer. Any transactions within a multinational group will all net out for tax purposes.

Finally, it should be noted that another of benefits of the OSS approach is that it prevents missing trader fraud.

#### **IV. Conclusions**

We have set out to consider issues in the design and implementation of a destination-based-based corporation tax. We draw on experiences of VAT to consider how such a tax could be levied. Our starting point is to ask how the tax could be implemented if it were applied in all countries, and how it would be applied within a group under an international cooperation setting where some, but not all, countries cooperate. We believe that it would be relatively straightforward to implement the tax in this case: the destination country has substantive jurisdiction to tax, with destination being at least as legitimate basis to tax as source, perhaps more; enforcement jurisdiction is *de facto* delegated by country of .destination on residence country, which collects the revenue under an OSS mechanism. We have so far considered only implementation issues when the tax is up and running. We have not so far addressed issues of transition.

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