Is the US DBCFT proposal the beginning of the end for the traditional residence-source paradigm?

Kluwer International Tax Blog

February 24, 2017

Guillermo O. Teijeiro (Teijeiro and Ballone)

Please refer tot his post as: Guillermo O. Teijeiro, 'Is the US DBCFT proposal the beginning of the end for the traditional residence-source paradigm?', Kluwer International Tax Blog, February 24 2017, http://kluwertaxblog.com/2017/02/24/us-dbcft-proposal-beginning-end-traditional-residence-source-paradigm/

In March, 2015, in wrote in this same pages: "The BEPS Project is subject to internal (inherent) risks (tight schedule, quality of outcomes, jurisdictional overlapping) as well as external risks (potential breach of the Nations' compact behind a common goal due to competing interests, and misaligned, premature and unilateral actions by States) which might conspire against the coherence and effectiveness of the final outcomes."

Turning to the external risks, and particularly addressing what at that point in time was already perceived as a US reluctant position towards the BEPS Project, I added that " …under heavy domestic pressure for a business-friendly tax reform … the Giant from the Americas still appears to look hesitant to fully and unconditionally embrace the BEPS Project. As we all know, if the compact of industrialized Nations breaks because of the US or another large player's defection, there is a potential risk that the monolithic will behind BEPS collapses, leaving room for a fierce competition on the global tax basis, and an aim of self-protection of each player's MNEs vis-a-vis foreign MNEs."[1]

The perception that the US was going to transient its own path towards overcoming the issues posed by business taxation in the international field while pursuing the protection of US MNEs grew up after: (i) the final outcomes of the BEPS Project were released in October 2015, since some of these outcomes were deemed below expectations because of a variety of reasons, including but not limited to complex and difficult to domesticate responses, lack of clear definitions on some crucial issues, and a level of optionality provided for under certain Actions Which does not help international (across-nation) consistency, and (ii) EC's state-aid cases against US MNEs erupted, in a move perceived at the other shore of the Atlantic as a persecution against US MNEs.[2]

As regards the BEPS Project's final outcomes back in November 2015 I observed that: "After two year of heavy work, the final report on the actions contemplated under the OECD-G20 BEPS Plan (consisting in more than 2,000 pages) were delivered on schedule, and approved by the G20, except for the case of the multilateral agreement … whose process is still active and programmed to be terminated under a tight schedule.

Soon after the October 5 final releases, all type of comments coming from government, academia and business organizations were made on the BEPS Plan's final outcomes; some very laudatory and others more or less critical. Some tax experts criticize that in some areas the outcomes did not go further, and others that at instances the standards adopted were too vague or remained open to optionality.

The business community remained concerned with the fact that some recommendations might lead to double or multiple taxation."[3]

"… At instances, as it happened with Action 1 and 7, on the digital economy and PEs, respectively, the discussion drafts had fell short and the final documents, instead of stepping forward with a more precise definition, simply recognized that countries may wish to go further individually, such as adopting a digital PE concept, a withholding (such as the UK DPT) on digital economy's yields, or some sort of equalization levy. The level of optionality in this area does not sound very promising in terms of consistency between national tax systems." … No clues are found on why formulary apportionment or other alternate paths to the arms' length principle (such as destination-based corporate tax) were not pursued further in this area, but one can easily imagine that abandoning the traditional paradigms of international taxation was beyond discussion."[4]

On the same topic, in a subsequent contribution I consistently added [5] "… looking at all the difficulties inherent to the application of traditional jurisdictional principles to the taxation of income from the digital economy, as well as the lack of a more decisive response from the BEPS Project, one may well wonder whether it would not be better to start considering a migration to a destination-based corporate tax model, a still untested but highly attractive alternative to tax income from the digital economy."

"And now it comes the implementation stage of the Plan where the risks are, inter alia, (i) a fierce states' competition on the grasping of the new (extended) global tax basis; (ii) a chauvinist sense of self protection on each player's MNEs vis-à-vis foreign MNEs, and (ii) the adoption of technically misaligned, uncontrolled, unilateral legislative measures which might lead to tax overlapping and cascade taxation in the international arena."[6] As regards the risk outlined in (ii) above, referral might be made, once again, to the US Treasury's view expressed in the White paper on EC's state-aid cases.

Finally, on the Multilateral BEPS Convention I wrote: "The recent appearance of the Multilateral Convention to Implement Tax treaty Related measures to prevent BEPS … rounded up the implementation of the treaty-related final BEPS package (actions 2, 6, 7, and 14) in one single document which will be open for signature as from December 31, 2016…The Convention aims to provide a framework that could amend all existing bilateral treaties at once (approx. 3,000) and bring them in line with BEPS treaty-related minimum standard without the need to endeavor complex and lengthy bilateral renegotiation…" [7]

Beyond my own judgement on the process, results, and complexities associated with the on-going implementation stage of the BEPS Project (including the Multilateral Convention), it is a fact that as from mid 2016 the US has been concretely moving towards an international business tax reform following a different path, as shown by the work of the Tax Reform Tax Force and the Ways and Means Committee of the US House of Representatives, comprised in the document issued in June, last year, calling for a destination-based cash flow tax (DBCFT),[8] and President Trump's proposal for a border adjustment tax.[9]

What a DBCFT consist of? DBCFT has two distinct components: (i) a cash flow element that gives immediate relief to all expenditures, including capital expenditures, and taxes revenues as they accrue, and (ii) the destination based element that introduces border adjustments similar to those under VAT, so that exports are untaxed while import are taxed. The relevant destination for the calculation of the tax is the location of the immediate purchaser and not necessarily that of the final consumer.[10]

By taxing business income at a relative immobile location, i.e., the location of the final purchasers of the goods and services (destination), DBCFT eliminates once and for all a number of the most significant state headaches coming from international business taxation under the traditional residence-source paradigm and its BEPS patch, i.e., the complexities inherent to the need to ascertain corporate tax residence as a primary element in the allocation of tax jurisdiction; tax avoidance maneuvers through inter-company transactions such as inter-company debt, shifting of royalty-producing intangible property to low-tax jurisdictions, and inter-company mispricing; it also assures neutral treatment of debt and equity as sources of corporate finance, and avoid source-source conflicts. DBCFT is also an efficient tool to allocate tax jurisdiction over income coming from a wide range of digital economy businesses, a matter which, as mentioned above, is one of the weakest fronts in BEPS' final outcomes,[11] and a source of trouble for policymakers in emerging (market) economies.

Thus, conceptually, and compared to BEPS patches, DBCFT has a number of meaningful advantages in connection with MNEs behavioral abuses in the international scene.

Of course, DBCFT's implementation is a major undertaking and a radical switch to a new paradigm in international taxation which would require substantial correlative changes regarding current domestic practice in corporate taxation and treaty law; besides, DBCFT still needs to sort out some international hurdles such as allegations that it contradicts WTO rules and, possibly, bilateral income tax treaties.

Another critical issue is whether, to be workable, DBCFT need to be adopted by all countries or at least a wide group of countries (though at different rates), or whether it could be introduced even by a single country. It is quite clear that the coexistence of origin-based and destination based taxation is not an easy game because of the profound inconsistencies between both regimes which would affect adversely the global company and state revenues as well. As regard the inter-jurisdictional relationship, the adoption of DBCFT by a single country or a small group of countries would more likely aggravate base erosion and profit shifting in coexistent jurisdictions that do not adopt it. The issue is of significant concern particularly if the early adopter is a large and initially high-tax country, e.g., the US. Bearing this in mind, one might well wonder whether the adverse impact on non-adopters may act as an incentive to the latter to follow the trend adopting DBCFT. Since no empirical experience exist so far, one may not but to speculate to which side the scale will move. But something is certain, should the US adopt DBCFT unilaterally, there would be an enormous tension in the international tax field and on the global company that will only cease if a mass migration towards DBCFT occurs.

Should the US passes DBCFT at some point in time (e.g., 2018), the maintenance of the traditional residence-source paradigm in the rest of the world would be at stake, and this of course exceeds the technical pros and cons of origin-based and destination-based taxation to become an across-nation competition game where, at the end, there would be winners and losers. As regards emerging economies, it is a fact that the potential adoption of DBCFT by the US will expand the practical menu of opportunities and policy decisions to make toward reinforcing their own tax jurisdiction, particularly with regard to stateless income, and easing administration and control over cross-border transactions.

Whether US adoption of DBCFT could be the beginning of the end for the traditional residence-source paradigm and recent efforts to keep it afloat by the OECD-G20 BEPS Project is perhaps quite premature to say; however, it is a fact that, for the first time, the US has taken DBCFT out of the claustrum and put it in the legislative agenda. Should this proposal go forward and be passed by the US Congress, DBCFT will produce an unprecedented tax revolution with worldwide ramifications. In this context, emerging economies should be following this process closely and starting to evaluate DBCFT as a workable alternate path to BEPS patches on traditional origin-based corporate taxation.

[1] *The OECD-G20 BEPS Project and the Challenges ahead*, Kluwer International Tax Blog, March 16, 2015

[2] On August 24, 2016, the US Treasury published a White Paper (*European Commission's recent State Aid investigations of transfer pricing rulings*), questioning the legal correctness of the moves against US multinationals under the EU State Aid provisions

[3] *BEPS Project at half way – Entering the implementation stage*, Kluwer International Tax Blog, November 30, 2015

[4] Id. footnote 2, above. See also, *The BEPS Project Lacks Comprehensive Definition on the Taxation of Digital Economy in Market Jurisdictions*, Kluwer International Tax Blog, October 24, 2015

[5] *Once more on a short-of-expectation BEPS outcome and the erratic domestication of a weak guidance: The case of the digital economy,* Kluwer International Tax Blog, August 29, 2016

[6] Id. Footnote 2, above

[7] *Multilateral BEPS Convention opens choices to LATAM countries*, Kluwer International Tax Blog, December 5, 2016; Schwarz, *BEPS Multilateral Convention Unveiled*, Kluwer International Tax Blog, November 25, 2016; and *Multilateral Negotiation of Bilateral Treaties*, Kluwer International Tax Blog, February 21, 2017.

[8] *A Better Way, Our visión of a Confident America*, June 24, 2016; https://waysandmeans.house.gov/taxreform/

[9] On this matter, from a conceptual perspective, see Auerbach A. & Holtz-Eakin D., *The Role of Border Adjustments in International Taxation*, jttps://www.americanactionforum.org/wp-content/uploads/2016/11/the-role-of-border-adjustment-in-international-taxation.pdf.; and, particularly, Auerbach, Devereux, Keen & Vella, *Destination-based Cash Flow Taxation,* February 6, 2017

[10] For example if a US manufacturer sells steel to a French automobile producer which uses the steel to produce automobiles sold back to the US, US application of the destination based tax would not tax the sale of the steel but would tax the automobile imports (accord. Auerbach, Devereux, Keen & Vella, cited paper, footnote 9.

[11] See European Commission, Commission Expert group on the Taxation of the Digital Economy, Report, May 28, 2014, at p. 49.