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U.S. Corporate Tax Reform: the Destination-Based Cash Flow Tax (DBCFT) and Tax Treaties

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As widely reported by the news media, a major corporate tax reform has been under discussion in the United States, which may cause spillover effects on taxpayers engaged in cross-border transactions. One of the proposals on the table is the Paul Ryan's blueprint "*A Better Way — Our Vision for a Confident America*", released by the House of Representatives Republican Tax Reform Tax Force on 24 June 2016[1].

The Ryan blueprint proposes the introduction of a destination-based cash flow tax (DBCFT), with a border tax adjustment (BTA), an innovative taxation model influenced by academic studies developed by Alan J. Auerbach and Michael P. Devereux[2].

Broadly speaking, the DBCTF basically functions in a similar manner to a subtraction type of Value Added Tax (VAT), in which export revenues are tax exempt, whereas imported products and inputs are taxed (non-deductible), combined with a subsidy for domestic wage payments in the form of deduction of all domestic payroll. The underlying idea is that the location of the consumer market cannot be artificially changed by multinational companies, which reduces existing incentives to manipulate transfer prices, to book profits abroad or to shift assets and production to other countries. In other words, by taxing U.S. multinationals based on the location of sales rather than the location of reported profits, it reduces the incentives for profit-shifting and international tax avoidance schemes.

Furthermore, the DBCTF may also reduce compliance costs and the harmful competition in the international tax environment, due to the immobility of the consumer market in comparison with the increasing mobility of production factors[3].

As revenues are tax exempt, export companies will probably accumulate tax losses, which should be subject to a tax refund in a theoretical DBCTF. However, in the Ryan blueprint, tax losses can be carried forward indefinitely, without the possibility of cash refund.

Moreover, the Ryan blueprint proposes the reduction of the corporate income tax rate from 35% to 20%, as well as the full and immediate write off of the cost of investments in tangible and intangible assets, which reflects the cash-flow tax component of the DBCTF. In turn, under the Ryan blueprint, companies will only be allowed to deduct interest expenses against interest revenues, with a carried forward mechanism that permits the deduction of net interest expense against net interest income in future years. In addition to avoiding base erosion, the removal of

interest deductibility also minimizes the debt bias. Interestingly, the immediate write-off of capital expenditures and the disallowance of net interest expenses also make the DBCTF similar to a subtraction type of VAT[4].

The Ryan blueprint also allows the tax-exempt repatriation of dividends from foreign subsidiaries of U.S. companies, maintaining the subpart F provisions only for passive income. Thus, it eliminates the worldwide tax system currently adopted by the U.S., replacing it with a participation exemption regime similar to those in force in EU countries. As a result, the DBCTF may also reduce corporate inversions, in which the US parent company with foreign controlled companies or subsidiaries is replaced at the top of the corporate group by a company incorporated abroad, in a low-tax jurisdiction or a country without CFC rules.

Despite the merits of the DBCTF and its innovative effects in tackling tax avoidance schemes, an interesting question that may arise here is whether the DBCFT falls under the concept of income tax under Article 2 of U.S. tax treaties, which would generate fruitful debates on its compatibility with certain treaty provisions.

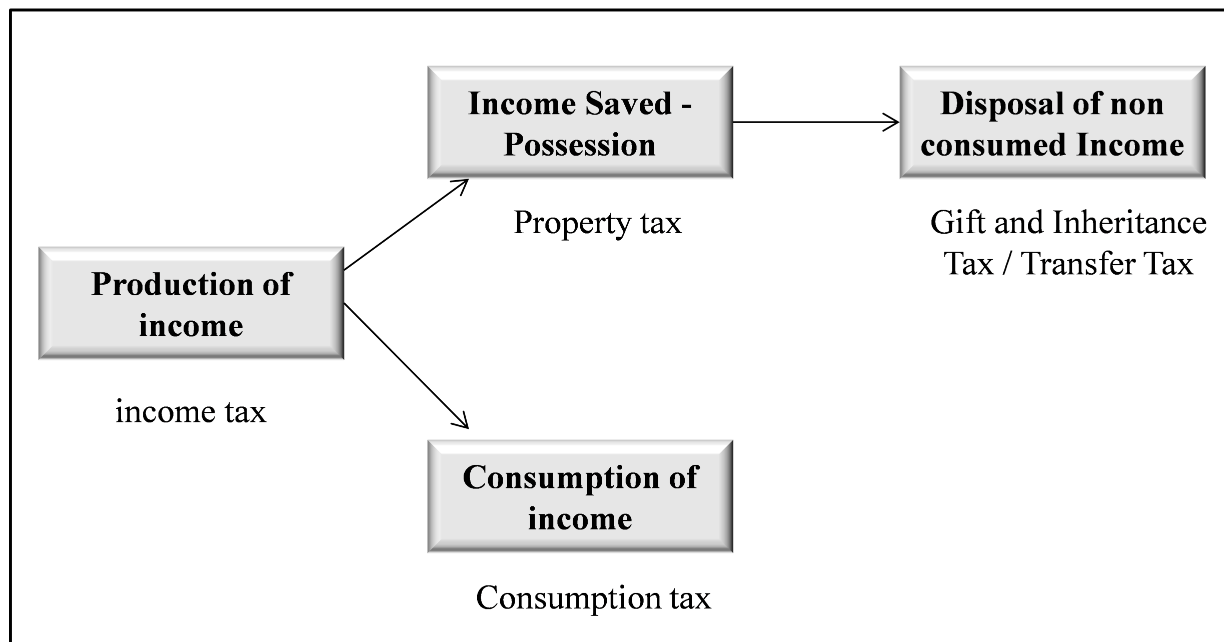
Article 2 (1) of the 2016 U.S. Model Convention ("MC"), which deals with the taxes covered, states that its objective scope covers "*taxes on income imposed on behalf of a Contracting State* ***irrespective of the manner in which they are levied***".

The definition of taxes on income and on capital gains is provided for by Article 2 (2) of the 2016 U.S. MC, which covers "*all taxes imposed on total income,* ***or on elements of income****, including taxes on gains from the alienation of property"*. As can be seen, this provision has a very broad wording, which encompasses not only a comprehensive income tax levied on the total income, but also specific taxes levied on particular types of income.

It may be debatable whether the DBCTF falls under the concept of income tax, since it is equivalent to a subtraction type of VAT combined with a wage subsidy. However, the DBCTF maintains some typical features of the income tax, such as:

- the use of a tax-inclusive rate, which corresponds to the standard approach in income taxation[5];
- the taxation of net investment income[6];
- the flow-through treatment of partnerships[7];
- the deduction of wages.

One could argue that the DBCTF is not substantially similar to an income tax, since it is assumedly borne by the consumers as a consumption tax, thus taxing the income in a different moment. The table below exemplifies the timing of taxation:



As known, the distinction between income tax and consumption tax was built on the idea that the former is borne by the person on whom it is imposed, while the latter is borne by the consumers of the products taxed, being passed on in prices. However, this idea is no longer completely accurate, which blurs the distinction between direct and indirect taxes[8]. From an economic perspective, the income tax may be borne by shareholders, suppliers, employees or consumers, which turns this criterion of differentiation very limited. Moreover, the DBCTF allows the deduction of wages, whereas such costs are not deductible in a normal VAT. This feature makes the DBCTF different from a classic consumption tax.

It follows that, if the DBCTF effectively replaces the corporate income tax charged in the U.S., being treated as such for all purposes, it would be considered as a substantially similar tax imposed after the date of the signature of the tax treaty in place of the existing corporate income tax, as provided for in Article 2(4) of the 2016 U.S. MC.

Assuming that the DBCTF may fall under the concept of income tax adopted in Article 2 of U.S. tax treaties, depending on how the legislation is drafted, the first problem that would arise concerns its compatibility with Article 7 ("*business profits*"), given the fact that the DBCTF taxes imported products in the absence of a permanent establishment in the U.S.

The definition of PE is one of the key concepts in tax treaties for the allocation of taxing rights relating to foreign business activities, serving as a criterion to legitimate the attribution of the taxing rights to the source state. It indicates a substantial degree of presence in the economic life of the source state, which justifies the taxation of a foreign person on the profits attributable to the business activity developed in its consumer market.

The DBCTF is justified under the claim that countries should be entitled to tax income derived from sales made to their customers[9]. Thus, by denying the deduction of imported products, it taxes the income in the customer's location.

One may argue that the DBCTF causes an economic double taxation, which would not be protected by tax treaties. However, the widely disseminated idea that tax treaties only cover juridical double taxation is not completely accurate. Tax treaties cover what is in the scope of their provisions, no matter if economic or juridical double taxation.

In fact, tax treaties may protect certain forms of economic double taxation, mainly in Article 7 ("*business profits*" – e.g. CFC rules), Article 9 ("*associated enterprises*" – e.g. correlative adjustments), Article 10 ("*dividends*" – e.g. advance corporate payment), Article 17(2) ("*entertainers and sportspersons*" – non-taxation of the star-company and the entertainer or sportsperson at the same time) and Article 25(3) ("*mutual agreement procedure*" – e.g. elimination of double taxation in cases not provided for in the Convention). Likewise, tax treaties do not cover all cases of juridical double taxation, such as dual source taxation, residual double taxation or double taxation caused by timing mismatches.

Therefore, the DBCTF can indeed be considered incompatible with Article 7 of U.S. tax treaties, since it ends up taxing the income of a non-resident company without the effective characterization of a PE within the U.S.

The second problem that may arise concerns the compatibility of the DBCTF with Article 24(4) of existing U.S. tax treaties ("non-discrimination"), according to which "(…) *interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State"*.

According to this provision, interest, royalties and other disbursements paid by a company in the source state to a beneficiary in the residence state must be deductible under the same conditions as they would be if they had been paid to a resident of the source state. The exceptions concerning Article 9, Article 11 (7), or Article 12 (6) of the U.S. MC, which preserve the right to adjust the remuneration in accordance with arm's length principle, are irrelevant to the matter under analysis here.

The restriction on the deduction of net interest expenses does not lead to a discriminatory tax treatment, since it applies to both residents and non-residents. The key problem lays in the fact that, due to the border adjustment, royalties paid to non-residents would not be deductible, while royalties paid to residents in the U.S. would be deductible.

It is important to clarify that the fact that a non-resident is not subject to full tax liability in the source State cannot be used as a justification to argue that residents and non-resident are not in comparable situations. In fact, unlike other provisions of the non-discrimination clause, Article 24(4) only mentions that certain payments must be deductible under the same conditions, without requiring a comparison between taxpayers. Nevertheless, even if it is assumed that a comparison test is inherent in the non-discrimination clause, the absence of full tax liability in the source State does not constitute a valid criterion to restrict the deduction of royalties, unless a payment made in the same condition to a resident without full tax liability (e.g. tax exempt entity) is also non-deductible for tax purposes.

Therefore, the introduction of the DBCTF by the U.S. may also lead to a discriminatory tax treatment of royalties paid to non-residents, which would be incompatible with the non-discrimination clause found in Article 24(4) of U.S. tax treaties.

In conclusion, despite the merits of the DBCTF and its innovative approach in tackling tax avoidance schemes, it should be acknowledged that its introduction by the U.S. would create practical issues not only from the perspective of the trade rules set by the World Trade

Organization (WTO), but also in relation to its incompatibility with the tax treaties signed by the U.S., specially Articles 7 and 24(4), as explained above.

[1] A Better Way: Our Vision for a Confident America, GOP Tax Reform Task Force (24 Jun. 2016), available at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf [perma.cc/G6B3-YMT3]

[2] A. J. Auerbach, M. P. Devereux, "Consumption and Cash-Flow Taxes in an International Setting", *Said Business School Research Paper* RP 2015-3 pp. 1-40 (27 Feb. 2015); A. J. Auerbach, M. P. Devereux, M. Keen, J. Vella, "Destination-Based Cash Flow Taxation", *Oxford University Centre for Business Taxation WP 17/01* pp. 4-94 (6 Feb. 2017); M. P. Devereux, R. Feria, "Designing and Implementing a Destination-Based Corporate Tax", *Oxford University Centre for Business Taxation Working Paper 14/07* pp. 1-22 (May 2014).

[3] W. Schön, "Destination-Based Income Taxation and WTO Law: A Note", *Working Paper of the Max Planck Institute for Tax Law and Public Finance* No. 2016-3, p. 1 (4 Feb. 2016).

[4] R. S. Avi-Yonah and K. Clausing, *Problems with Destination-Based Corporate Taxes and The Ryan Blueprint* p. 6 (21 Jan. 2017), available at www.law.ucla.edu.

[5] J. Becker, J. Englisch, "A European Perspective on the US Plans for a Destination Based Cash Flow Tax" p. 4, available at: https://ssrn.com/abstract=2924313.

[6] M. J. Graetz, "The Known Unknowns of the Business Tax Reforms Proposed in the House Republican Blueprint", *Columbia Journal of Tax Law*, Vol. 8, No. 117, 2017 (2 Feb.. 2017) p. 5, available at SSRN: https://ssrn.com/abstract=2910569.

[7] Id.

[8] P. Harris, *Corporate Tax Law – Structure, Policy and Practice*, Cambridge Tax Law Series pp. 3-4 (Cambridge University Press 2013).

[9] M. Devereux and R. de la Faria, "Designing and implementing a destination-based corporate tax", WP 14/07 (Oxford University Centre for Business Taxation 2014), p. 12.

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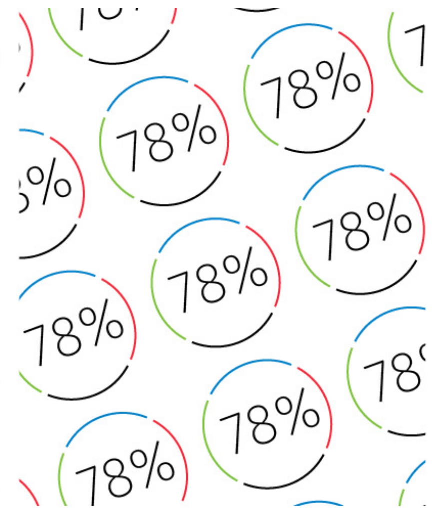

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