The Destination-Based Corporation Tax: A Solution to Formalism in Source-Based Taxation?

*Shaun Matos**

Introduction

The taxation of multinationals has become one of the biggest issues in modern discourse. With fierce market competition, it is unsurprising that businesses have started to view tax obligations as a cost to be minimized rather than as a social or political obligation. Such behaviour is problematic not only for the effects it has on government revenues, but also for its link to other problems such as competition and distortions. Many of these problems relate to the mechanics of source-based taxation and are linked to the fact that the definition of 'source' is unclear, slippery, and open to manipulation. The source-based system as a whole is very formalistic, in that it looks only to the place where multinationals have chosen to locate their profits rather than to the place where profits are actually generated. This formalism will be explored further in this article.

Yet, if we believe certain commentators, we may not have to give up hope on finding a tax system which provides a solution to these problems. A number of academics have built on the work of the Meade Committee to argue in favour of a Destination-Based Cash Flow Tax (DBCFT), a version of which was once supported by the Republican Party (GOP). It is argued that, if universally adopted, this approach would alleviate many of the problems that the source-based system currently produces. Much of this rests on 'destination' being a more certain and less formalistic concept than 'source'. This paper will examine

* LLM Candidate at University College London, BA (Cantab). With thanks to Dr Dominic de Cogan for his initial supervision of the article, Professor Rita de la Feria for her additional comments and the editors for their thoughts and advice.

this claim, drawing heavily on VAT literature. It will be argued that, whilst the destination principle does indeed deal with some of the major problems of the source-based system, there are still a number of practical problems inherent in any destination-based system. Although there will be a brief mention of the economic debates and some of the wider legal issues, the focus will be on whether the tax and the destination principle it relies upon, can be implemented in a less formalistic manner. The potential issues can be seen most clearly when considering multi-location entities and branch mismatch arrangements. The first part will briefly explore the problems of source-based taxation and the solutions which the DBCFT purports to provide. The second part will then consider whether this system could actually be implemented.

I. Part I

A. The basics: source and destination

Before proceeding any further, it is necessary to develop an understanding of the difference between 'source' and 'destination' as tax bases. Griffith, Hines, and Sørensen define source-based taxation as the system in which "capital is taxed only in the country where it is invested"[1] resulting in a tax on investment. Hence, if Company X invests in Country A and sells into Country B, a source-based system requires that X only pays tax in A. The authors give a brief explanation of the economic effect of such taxation in a small open market. As they argue,

> if the domestic government imposes a source-based business income tax, the pre-tax return to domestic investment will have to rise by a corresponding amount to generate the after-tax return required by international investors. Hence, domestic investment will fall and capital will flow out of the country until the pre-tax return has risen sufficiently to compensate investors fully for the imposition of the source tax. Thus, the incidence of a source-based capital tax falls entirely on the immobile domestic factors of production (land and labour).[2]

It should be noted that the source-based system is not the only model currently in use. There is also a 'residence-based system' under which companies are taxed by their country of residence on their worldwide profits, and most

[1] Rachel Griffith, James Hines, and Peter Birch Sørensen, "International Capital Taxation". in James A Mirrlees and Stuart Adam (eds), Review, *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press 2010) 925.

[2] ibid.

national tax codes adopt a combination of both systems to maximize their tax receipts.[3] The source-based model, however, is predominant[4] and is the one that the proponents of the DBCFT focus on. The residence-based system will therefore not be discussed any further.

There are three core elements to the DBCFT. The basic idea behind the 'destination' element is that, similar to a VAT, tax is levied based on the location of the customer rather than that of the supplier.[5] There is, however, one crucial difference between the DBCFT and the VAT. Even though VAT is usually conceived as being a tax on consumption, in the majority of cases it will be impossible to know where the good or intangible is consumed (as opposed to purchased).[6] Hence, when VAT is charged on a transaction, the location of the customer is merely a proxy for the place of consumption. Often there will be numerous intermediaries in a chain of transactions before the product is finally consumed, meaning that identifying the location of a customer may not be enough. Other proxies, such as the location of the goods, are therefore used in conjunction.[7] The destination of the customer is, however, still critical to VAT's staged collection mechanism.[8] The DBCFT, on the other hand, is not a tax on consumption, but on either profit or imports. Destination here is therefore not a proxy for consumption,[9] in the sense that in most cases there is no need to use a combination of proxies to determine the appropriate place of taxation. This will be discussed in Part II section B.

The second part is the cash flow element. This is based on a proposal initially put forward by the Meade Committee, and can be explained as follows:

> [A] cash flow tax applies to net receipts arising in the business. Receipts are included in the tax base when payment is received and expenses are recognized when payment is paid. The tax base in any given period is the former less the latter. The most significant difference in the timing of the inclusion of receipts and expenses in the base, compared with most existing corporate tax systems, is

[3] See, for example, Section 5(1) of the Corporation Tax Act.

[4] See Article 7 of the Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Publishing 2017).

[5] Alan Auerbach, Michael Devereux, and Helen Simpson, "Taxing Corporate Income". in James A Mirrlees and Stuard Adam (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press 2010) 839 and 883. See also Section 9.6.3 more generally.

[6] Organisation for Economic Co-operation and Development (OECD), *International VAT/GST Guidelines* (OECD Publishing 2017) 17.

[7] Michael Devereux and Rita de la Feria, "Designing and implementing a destination-based corporate tax" (2014) *Oxford University Centre for Business Taxation* Working Paper Series 14/07, 16 <http://eureka.sbs.ox.ac.uk/5081/1/WP1407.pdf> accessed 1 May 2018; Rebecca Millar, "Cross Border Services - A Survey of the Issues". in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomas Bookers Ltd 2007) 322-323.

[8] OECD, (n 6) 38.

[9] Devereux and de la Feria, (n7) 10.

that under cash flow taxation even capital assets that are typically depreciated over time are immediately expensed.[10]

There are two variations: an R-based system which ignores transactions involving financial assets and liabilities, and an R+F-based system which includes financial as well as 'real' flows.11 There is a significant amount of academic discussion on this part of the tax.12 Because of space constraints and the focus of other literature, however, this paper will only focus on the 'destination' aspect of the tax.

This leads to the final element of the tax which is key to explaining how the previous two aspects operate in practice. Under the border-adjustment mechanism, the liabilities of a taxable entity differ depending on whether the entity is an importer or an exporter. If it is an exporter, the mechanism operates to reduce the business' tax burden by zero rating exports, with the result being that they are not included in the business' taxable profits. If, on the other hand, the business is an importer, the mechanism operates so as to impose a tax on the imported goods. This could be done in one of two ways: (a) by directly taxing the import and allowing the importer to deduct the price of the import from its tax base, or (b) by not taxing the import but not allowing a deduction for the cost of the import.[13] In either way, the effective tax base is domestic sales minus domestic costs.[14]

The potential benefits that many find in the tax when compared with a source-based system will be explored below, but it is, at this point, worth briefly exploring the potential economic effects of the tax. Those in favour argue that the DBCFT would be trade-neutral for any individual state because, even though exports would become cheaper and imports more expensive, an increase in the price of labour and an appreciation of the exchange rate would result in

[10] Alan Auerbach, Michael Devereux, Michael Keen, and John Vella, "Destination-Based Cash Flow Tax" (2017) Oxford Legal Studies Research Paper 14/2017, 9 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2908158&download=yes> accessed 1 May 2018.

[11] ibid.

[12] David A Weisbach, "A Guide to the GOP Tax Plan - The Way to a Better Way" (2017) University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 788, 288 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2893224&download=yes> accessed 1 May 2018; James E Meade, *The Structure and Reform of Direct Taxation* (Allen and Unwin 1978).

[13] Auerbach, Devereux, Keen, and Vella, (n 10) 14; Weisbach, (n 12) 27-28. Despite the fact that there are two ways in which the tax could operate, much of the analysis in the papers referred to seems to assume that, in relation to businesses at least, the second version of the DBCFT would be adopted. Therefore, unless specified otherwise, the discussion below assumes that it is the second model of the DBCFT that is being adopted.

[14] The Economist, "How America's border-adjusted corporate tax would work" (*The Economist* 13 February 2017) <https://www.economist.com/blogs/economist-explains/2017/02/economist-explains-9?fsrc=scn/tw/te/bl/ed/> accessed 1 May 2018.

an equilibrium.[15] It is difficult to predict with certainty whether prices and the exchange rate would adjust in this way, especially in the case of unilateral adoption, but it is sufficient to say that it is, at least theoretically, possible for the tax to have no effect on the balance of trade.

Before moving on, it is worth highlighting the distinguishing features of the DBCFT. Firstly, exports are not included in the tax base (and it is possible to get a tax credit).[16] Secondly, businesses are unable to deduct the cost of imports from the tax base unless a direct tax is imposed on the import. Thirdly, businesses are able to deduct labour costs from the tax base. It is these features, and especially the first two, which are relied upon to eliminate the formalism in the source-based system.

B. The problems of a source-based corporation tax

The problems of a source-based corporation tax are numerous, so this section will focus on those in which the impact of formalism is the clearest.

1. Avoidance

As mentioned in Part I section A, the opportunity for avoidance is perhaps the gravest issue that the current system faces, especially considering the fact that a number of other problems flow from it. The literature focuses on three main methods of avoidance, so it is these methods that will be considered here.[17]

The first method, namely debt shifting, has more to do with the cash flow aspect of the DBCFT (see Part I, section C(1)) and it will be considered only briefly. The basic idea is that a company or group with establishments in multiple jurisdictions can strategically lend money between jurisdictions to take advantage of the most favourable rules regarding tax relief and interest income. The result is that multinationals will borrow in high rate jurisdictions to reduce the taxable profits there.[18] Such groups may also then use subsidiaries in low rate jurisdictions to lend to affiliates in high rate jurisdictions as the deductible interest payment in the high rate country will likely exceed the taxable interest receipt in the low rate jurisdiction. It is unnecessary to undertake an in-depth analysis of this example to see the formalism inherent in the system; multinationals can easily use debt

[15] Auerbach, Devereux, Keen, and Vella, (n 10) 17-21.

[16] The presence of tax credits may cause further problems in itself. For this, see Reuven S Avi-Yonah and Kimberly A Clausing, "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint" (2017). University of Michigan Law & Economics Research Paper 16-029, 17-18 <https://ssrn.com/abstract=2884903> accessed 1 May 2018; Weisbach, (n 12) 55.

[17] Auerbach, Devereux, Keen, and Vella, (n 10) 27-30.

[18] ibid.

to locate their profits in the most tax-efficient way because of the inability of the source-based system to look beyond the locations chosen by multinationals.

Manipulation of intra-group pricing is the second method outlined in the literature and is much more significant for the purposes of this paper. It occurs when companies, which are related to or part of the same multinational group, trade with each other and misstate the price of the relevant goods. For example, if State A has a higher tax rate than State B, there is an incentive to understate the true price of goods transferred from a company in A to a company in B because B's tax relief will exceed the tax levied on A's sale.[19]

The consequence is that the company in the high tax jurisdiction seems to be significantly less profitable. It is easy to see that this method is again largely inefficient because of the formalism and vagueness of 'source' as a basis for taxation. Despite the fact that tax is supposed to be levied where the profit-generating activity is carried out, the formal and artificial location of the profits is the focus of a source-based inquiry. Multinationals therefore are free to enjoy the best of both worlds, meaning that they are able to locate their production centres in the jurisdictions which have the best resources while paying tax in whichever jurisdiction is most beneficial. Hence, a more substantive approach is needed.

The final method pointed out by supporters of the DBCFT is the placement of valuable intangible assets in low tax jurisdictions. The parts of the multinational located in high tax jurisdictions pay royalties in return for the use of assets, giving tax relief at the high rate and giving rise to a tax receipt in the low tax jurisdiction.[20] Again, it is not difficult to see that the uncertainty inherent in the concept of 'source' is responsible for this. Whilst, on a formal level, the asset appears to be generating profit in the low tax jurisdiction, it is often the case that the asset will have been developed elsewhere and then sold to a related company in a low rate jurisdiction. This means that the true source of the revenue, namely the work done to produce the asset, will be hidden.

Before moving on, it is worth noting that a number of measures have been taken to address these issues. One measure is the arms-length pricing rule, which stipulates that related parties must deal with each other as if they were entirely independent to prevent manipulation of intra-group prices. At first glance, this does appear to prevent parties from abusing the formalism of the 'source' concept, but there are a number of problems with this solution in practice. The Mirrlees Review points out that this principle can be difficult to apply where transactions involve highly specialised products which may not be traded by other commercial parties. Moreover, in extreme cases, the principle may break down completely

[19] ibid.
[20] ibid.

where the product is unique and there are no comparable transactions taking place in the normal market.[21] In such cases, it is difficult to identify the true market price of the product and hence, the places where profits are actually being generated. Indeed, Mirrlees goes even further to suggest that the principle may be generally flawed because it cannot take into account other advantages multinationals will likely enjoy from trading with related parties.[22] Hence, it is clear that, despite efforts to close these avoidance channels, the formalism of a source-based tax means that companies are able to conceal the true location of their profits with relative ease.

2. Efficiency

Connected to these avoidance mechanisms is the distortionary effect source-based taxation can have. Auerbach, Devereux, and Simpson set out the stages of an investment decision and point out how each stage can be affected by tax considerations.[23] For example, different rates of corporation tax can affect a company's decision whether to expand by producing more domestically or abroad. Further, as mentioned, source-based taxation can also be an important factor in deciding where profits should be located and how a multinational should be structured. It is true that tax is not the only factor which affects business decisions but, given the significant empirical evidence in favour of this analysis,[24] one is led to the conclusion that the formalism of a source-based system can, and does, result in significant distortions.

3. Tax Competition

A further issue concerns the competition generated between states. As authorities become aware of avoidance mechanisms and the distortionary effect of taxation, it is only natural that they try to maximise their revenues by creating favourable environments. There is, however, a real risk of a race to the bottom. Since 1978 the main rate of corporation tax in the UK has fallen from 52% to 19% and is scheduled to drop further. Similar falls can also be seen in other countries.[25] Of course, changes in tax rates cannot be viewed in isolation; one must

[21] James A Mirrlees and Stuart Adam, *Tax by design: the Mirrlees Review* (Oxford University Press 2011) 434-436.

[22] ibid.

[23] Auerbach, Devereux, and Simpson, (n 5) 853-855.

[24] ibid.

[25] Stuart Adam, James Browne, and Christopher Heady, "Taxation in the UK". in James A Mirrlees and Stuart Adam (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press 2010) 25; UK Government, "Rates and allowances: Corporation Tax" (UK Government, 1 April 2018) <https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax> accessed 1 May 2018.

remember that the fall in rates has been accompanied by a broadening of the tax base and that the share of corporation tax receipts in total revenue and GDP has not significantly changed.[26] Further, decisions to reduce the rate of corporation tax may also have been influenced by a desire to remove capital controls to welcome international investors. Nevertheless, efforts to compete on rates and more widely, with other states for tax revenues may lead to the creation of further distortions and the usage of avoidance mechanisms. It is easy to see how a vicious circle can be formed over time. More broadly, in a globalised world where cooperation is key to tackling issues such as avoidance, a system which incentivises competition is evidently not a good thing.

A. The promises of the DBCFT

While the Organization's for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project attempts to provide a solution to the problems outlined in section B, those in favour of the DBCFT suggest that their model can provide a neater and simpler solution. The model does appear to be successful in avoiding the problems outlined because a destination-based tax system avoids some of the formalism and uncertainty inherent in the source-based system. Given the close link between avoidance and other issues outlined above, this section will mainly focus on the DBCFT's solutions to avoidance mechanisms.

1. Avoidance

As stated, preventing the shifting of debt is more closely related to the cash-flow element of the tax. In short, the cash-flow element can come in a number of guises, the most likely of which to be adopted are the R-based system and the R+F-based system. Under the R-based system, there would be no consequences for either interest payments or interest receipts.[27] Hence, this method of avoidance would simply not exist. The R+F base, on the other hand, applies to "all net financial inflows other than equity transactions with [...] shareholders".[28] The exact mechanics of the R+F version are complex and not relevant to the main argument of this paper.[29] For present purposes, it is enough to say that the debt-shifting channel would not be available under the R+F system either.[30] The cash-

[26] Adam, Browne, and Heady, (n 25) 8.
[27] Meade (n 12); Auerbach, Devereux, Keen, and Vella, (n 10) 9-10.
[28] Auerbach, Devereux, Keen, and Vella, (n 10) 45.
[29] ibid, 45-63.
[30] ibid, 27.

flow element of the tax, therefore, appears to eliminate the formalism of the source-based system.

Of more relevance is the manipulation of intra-group prices. The destination principle means that an exporting company faces no domestic taxes as exports are zero-rated and the importing company will be liable instead. Under the first version of the DBCFT, this liability will take the form of an import tax accompanied by a deduction of the price of the import from the company's tax base. We are told that these "effects exactly cancel out, making the value of the import irrelevant for tax purposes".[31] Under the second version of the DBCFT, where imports from taxable businesses are simply excluded from tax calculations, the transaction between the related parties is free of tax.[32] Cross-border transactions, therefore, apparently have no tax implications for either party in the sense that a multinational cannot manipulate its tax liability. The authors also point out this 'netting out' of business-to-business (B2B) transactions removes the opportunity under the less popular formulary apportionment system for a highly profitable company to sell its products in an arms-length transaction to a less profitable company in a low-tax jurisdiction which would then re-sell the goods to consumers in a high tax jurisdiction and pay the high rate of tax on its low profits.[33] The foregoing discussion appears to show that the formalism, which plagues the source-based system, would not be an issue if it is possible to implement the DBCFT: companies simply wouldn't be able to misrepresent the location of their profits in the same way.

The final method mentioned above concerning the location of intangible assets would also be eliminated. Regardless of the source of the asset, it will be taxed at the full rate in the jurisdiction in which it is sold, with the tax in the destination jurisdiction again being deductible for the receiving company. As the tax liability is the same wherever the asset is located and it is not possible to mask the true destination of the asset, the DBCFT seems to rule out this channel of avoidance as well.[34]

2. Efficiency and Competition

As noted in section B, the source-based system has considerable distortionary effects, but this does not seem to be an issue under the DBCFT. One reason for this relates to the preceding discussion as there is no incentive for businesses to shift their profits. The second reason is that consumers are relatively immobile and thus they are unlikely to change locations because of tax rates. It follows that there is no

[31] ibid, 29.
[32] ibid, 28.
[33] ibid.
[34] ibid, 29-30.

incentive for states to compete on tax rates.[35] Auerbach, Devereux, Keen, and Vella note that one potential issue is that firms may have an incentive to locate expenses in a country with a higher rate of DBCFT because that gives them the option to deduct expenses from profits. After carrying out an in-depth economic analysis of the consequences of doing this, however, the authors suggest that changes in demand from both the lower and higher rate jurisdictions would lead to an upward pressure on the currency of the higher rate jurisdiction. The value of profits earned, therefore, increases and sets off the higher rate of tax. If such analysis is correct, it shows that, once the formalism and uncertainty of the source-based system are removed, many of the problematic consequences that flow from it seem to disappear. Instead, business decisions will be driven by other economic factors and tax policy will be implemented in an international environment characterised by cooperation rather than competition.

II. Part II

A. Some basic problems

Given the analysis in Part I section C, it is fair to say that the DBCFT does indeed resolve some of the problems which currently exist in the source-based system. Nevertheless, it has some issues of its own. Before moving onto a more detailed analysis of the destination principle, there are some initial problems with the DBCFT that should be outlined in the interests of completeness. Indeed, many of these problems may be in and of themselves big enough to make the implementation of the tax difficult, if not impossible.

1. WTO Rules

The first major problem is that the tax may be viewed as incompatible with the World Trade Organization's (WTO) rules. The WTO Subsidies and Countervailing Measures Agreement and the Article 16 of the GATT outlaw export subsidies, the definition of which appears to cover a border-adjustable direct tax, stipulating that: "(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes (58) or social welfare charges paid or payable by industrial or commercial enterprises (59) (Annex 1)".

Footnote 58 then defines 'direct tax' as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property". This seems to straightforwardly cover the DBCFT. It is true that

[35] Ibid, 23-26.

VAT, as an indirect tax, is not incompatible with this rule. Nonetheless, the major difference between the two is that the DBCFT allows labour costs to be deducted, whilst VAT does not. This may seem like a minor difference but Avi-Yonah and Clausing show that it results in exports being subsidized by the state in a way they would not be under VAT.[36] There are three further factors that point away from the DBCFT being treated as analogous to VAT: (a) the overall tax base being the profit of the enterprise rather than the value added; (b) the intention that the tax being borne by the owners of capital rather than final consumers; and (c) the fact that the tax is levied based on where the taxpayer delivers the service or goods rather than where consumption occurs.[37] It may be possible to get around this problem by taking the deduction for labour costs outside of the tax. How this could be done and what effects it could have on the rest of the tax system is, however, unrelated to the destination principle and so, outside the scope of this paper.[38]

2. Currency Exchange

As we have seen in Part I section C, the ability of the DBCFT to eliminate the distortionary effects tax can have on investment decisions seems to be one of its major advantages, even where tax rates are not the same across jurisdictions. This depends, however, on upwards currency pressure cancelling out the effect of the higher rate of tax[39] which is a proposition not all economists accept. Gale, for example, points out that such analysis assumes that capital market flows would not be affected, but argues that this is in fact very likely to happen.[40] He also points out that there are a number of other factors that make it difficult to estimate the effects of border adjustment on the exchange rate in practice; these include slow adjustment of prices and pre-existing contracts affecting exchange dynamics.[41] Rogoff also criticises this kind of modelling, suggesting that it is extremely difficult to use structural modelling to predict exchange rate volatility.[42]

Avi-Yonah and Clausing point to a number of other issues, such as the fact that many countries fix their exchange rates making it difficult to predict the effect

[36] Avi-Yonah and Clausing, (n 16) 5-14.

[37] ibid.

[38] There is also a range of other WTO issues, such as discrimination of like products which is forbidden by GATT, Article II, [2] and [4].

[39] Auerbach, Devereux, Keen, and Vella, (n 10) 25-26.

[40] William G Gale, "Understanding the Republicans' corporate tax reform" (*Brookings* 10 January 2017) <https://www.brookings.edu/opinions/understanding-the-republicans-corporate-tax-reform/> accessed 1 May 2018.

[41] ibid.

[42] Kenneth Rogoff and Martin Feldstein, "Perspectives on Exchange Rate Volatility". in Martin Feldstein (ed), *International Capital Flows* (University of Chicago Press 1999) 444.

on the it.[43] If such doubts are correct, this significantly undermines the efficacy of the DBCFT. Not only does it impair the neutrality of the tax, but it can also have an impact on trade and consumer prices. Weisbach argues that, even if the models are correct and the adjustment would take place, the transition could be slow and rocky, potentially still having a significant negative effect on importers.[44] The uncertainty surrounding this aspect of the proposed tax makes it difficult to envisage it being implemented by any but the bravest of governments.[45]

A. Learning from VAT

There are a number of differences between the DBCFT and the VAT. The VAT is, in theory, an indirect tax on consumption whereas the DBCFT is a direct tax, either on corporate profits or imports. Consequently, the DBCFT gives relief for labour costs whereas the VAT does not because the value added is equivalent to the profit earned plus the amount paid for labour. Moreover, the DBCFT is not reliant on proxies in the same way as the VAT is, and the collection mechanisms for each differ. Most VATs rely on the invoice credit method under which the supplier charges the customer VAT on each transaction.[46] If the customer is a VAT-registered business, it can credit this VAT against output taxes charged on sales. The importance of this collection method is difficult to overstate, something that can be seen by the fact that the OECD report calls it "the central design feature of a VAT".[47] In contrast, the DBCFT uses the subtraction-based method which looks much more like a traditional corporation tax.[48] Under the subtraction-based method, an annual account is taken of sales and input costs (labour costs are not included where the tax is VAT but are where it is the DBCFT) are deducted.[49] This distinction will become important in the following discussion. It is important to emphasize, at this point, the sense in which destination will be used. As both a VAT and the DBCFT tax imports rather than exports, we are concerned mainly with the jurisdiction of the imported product rather than the jurisdiction of any later exports. Despite the differences, the destination of the goods or service is vital to both. We can, therefore, learn a lot from the mechanisms in which the concept has operated in the VAT context and the problems that have arisen there. Much of the rest of this paper will explore the inconsistent implementation of the destination

[43] Avi-Yonah and Clausing, (n 16) 11.

[44] Weisbach, (n 12) 46.

[45] These examples are illustrative only. There is also a range of further issues such as the effect on tax treaties. See Weisbach (n 12) and Avi-Yonah and Clausing (n 16) for further discussion.

[46] OECD, (n 6) 15.

[47] ibid, 14

[48] Auerbach, Devereux, Keen, and Vella, (n 10) 16; Meade, (n 12) 86-88.

[49] Auerbach, Devereux, Keen, and Vella, (n 10) 16.

principle across jurisdictions. It will be argued that, despite the apparent success of the DBCFT in closing avoidance mechanisms which exist under the source-based system, it is unable to implement the destination principle in a way that does not create new avoidance mechanisms. This can be seen most clearly in the context of transactions involving services and intangibles. Whilst solutions may be available in the VAT context, they cannot be readily applied to the DBCFT. Discussion of this problem will show that in practice the concept of 'destination' is not as certain and substantive as the preceding section would suggest and may cause significant problems if the DBCFT were to be implemented.

1. Defining and Implementing Destination

A broad distinction can be drawn between two types of trade: trade of goods, on the one hand, and the trade of services and intangibles, on the other. The treatment of the destination principle with regards to goods can be dealt with fairly briefly because the existence of border controls and fiscal frontiers means that it is simple to identify the place of delivery.[50]

Trying to find a way to consistently implement the destination principle with regards to services and intangibles is far more difficult because, unlike goods, the nature of services and intangibles means that they cannot be subject to border controls.[51] As the traditional approach of determining the place of consumption by the location of the provider is clearly insufficient in a globalised world, a new way must be found. Keen and Hellerstein helpfully divide this category up into 'tangible services' and 'intangible services'.[52] The former category refers to services "with respect to which sensible proxies for consumption can be identified by reference to the location of the performance of the services, or their link to the location of the property, rather than the location of the customer". While determining which jurisdiction collects VAT in such cases can be relatively straightforward where the customer's location is used as a proxy; Millar points out that this is not always the case. Sometimes other proxies, such as the location of relevant goods, the location of immovable property, and the place of effective use and enjoyment are used instead.[53] Given that "VAT regimes differ in the way that they combine the proxies, the order of their application and the priority given to each proxy",[54] there appears to be a real risk of double or nil-taxation. Despite these problems, this category

[50] OECD, (n 6) 17.
[51] ibid.
[52] Walter Hellerstein, and Michael Keen, "Interjurisdictional Issues in the Design of a VAT" [2010] 63(2) Tax Law Review 372.
[53] Devereux and de la Feria, (n 7) 322-323.
[54] Hellerstein, and Keen, (n 52) 374.

of services is unlikely to be an issue for the DBCFT because, unlike the VAT, the DBCTF is not concerned with the location of consumption. The location of the customer is *always* the focus of the DBCFT so there is no need to become concerned with other proxies.

The second category concerns services which, in contrast, do not have a connection with any identifiable physical location. Unlike 'tangible services', there is no location or physical element which can be relied on to provide a means of identifying the place of consumption in place of border controls. There are two distinct scenarios here: business-to-business transactions and business-to-consumer transactions.[55] Within business-to-business transactions, there is a further divide between sales to single location entities (SLEs) on the one hand, and sales to multiple location entities (MLEs), on the other. Given that in business to consumer contexts it is relatively straightforward to identify the location of the consumer, this issue will not be considered further.[56]

Moreover, where the customer in a business to business transaction is a SLE, the solution is straightforward.[57] The problem, however, is more complex where the customer is an MLE. In such circumstances, it is often unclear which establishments have used the service or intangible and hence, which jurisdictions have taxing rights.[58] This means that, unlike in the discussion above, the problem is not unique to VAT. It has nothing to do with destination being a proxy for consumption or the use of different combinations of proxies. Rather, it is about finding the real destination of services or intangibles in any given transaction, meaning that it is inherent in *any* destination-based system. Therefore, unless there is a single set of rules that determines the destination of services and intangibles, there is a risk that the universal adoption of the DBCFT may lead to gaps and overlaps in the taxation of corporations. This problem is acknowledged by the supporters of the DBCFT but it is dealt with fairly briefly by simply recommending the adoption of the OECD's guidelines.[59] It will become clear that this lack of discussion, in particular on the issue of whether the OECD's guidelines are applicable in a DBCFT context, means that the tax's formalism and susceptibility to avoidance have not been sufficiently recognized.

The OECD's 2017 International VAT/GST Guidelines attempt to deal with the issue of defining and implementing 'destination' in a VAT context. Guideline 3.2 says: "[f]or the application of Guideline 3.1 [which recommends the use of the destination principle] for business-to-business supplies, the jurisdiction in which

[55] OECD, (n 6) 38.
[56] ibid, 64-72 for further detail.
[57] ibid, 44.
[58] ibid, 45.
[59] Devereux and de la Feria, (n 7) 17; Auerbach, Devereux, Keen, and Vella, (n 10) 79.

the customer is located has the taxing rights over internationally traded services or intangibles". Guideline 3.3 supplements this by stating that, "[...] the identity of the customer is normally determined by reference to the business agreement". In situations where the customer is a SLE, this rule is easy to implement: all the supplier needs to do to ensure the export is free of tax is to identify and demonstrate who their customer is and where they are located. This would be easy for the parties to do and for tax authorities to monitor.

The picture is, however, more complicated where the customer is an MLE, as it is necessary "to determine which of the jurisdictions in which the MLE is located has taxing rights over the service or intangible acquired by the MLE".[60] Guideline 3.4 suggests that "where the customer has establishments in more than one jurisdiction, the taxing rights accrue to the jurisdiction(s) where the establishment(s) using the service or intangible is (are) located". This much is obvious. The difficulty arises when trying to determine which establishment is using a service or intangible. The report identifies three broad categories of approaches which are currently being used by different jurisdictions: (a) the direct-use approach, which focuses on the establishment that uses the service or intangible; (b) the direct-delivery approach, which focuses on the establishment to which the service or intangible is delivered; and (c) the recharge method, which focuses on the establishment that uses the service or intangible as determined on the basis of internal recharge arrangements within the MLE, made in accordance with corporate tax, accounting or other regulatory requirements.[61]

Each of these methods has its own difficulties. The report notes that the 'direct use' approach may not be particularly helpful where it is unclear at the time of the agreement which customer establishment will actually use the service or intangible, or where the service or intangible will be used by different establishments in different jurisdictions.[62] The utility of the direct delivery approach is limited to where there is physical delivery, and hence it is of little assistance in the kind of services and intangibles presently being discussed. The 'recharge method' is more complicated, so it is necessary to explain this approach in detail to identify its problems. Under the 'recharge method', MLEs must "internally recharge the costs of externally acquired services or intangibles to their establishments that use

[60] OECD, (n 6) 45.
[61] ibid.
[62] ibid, 46.

these services or intangibles, as supported by internal recharge arrangements".[63] A two-step approach is suggested by the report:[64]

> The first step follows the business agreement between the external supplier and the MLE. The taxing rights over the supply to the MLE are allocated to the jurisdiction of the customer establishment that represents the MLE in the business agreement with the supplier. The second step is required when the service or intangible is used wholly or partially by one or more establishments other than the establishment that has represented the MLE in the agreement with the supplier. This second step follows the internal recharge made by the MLE for allocating the external cost of the service or intangible to the establishment or establishments using this service or intangible. This internal recharge is used as the basis for allocating the taxing rights over the service or intangible to the jurisdiction where these establishment(s) of use is (or are) located, by treating this internal recharge of the externally acquired service as within the scope of VAT.

This method does appear to deal with the issue of the supplier (and potentially the customer) not knowing which establishment(s) will use the service or intangible at the date of the agreement, but it is not without problems. The report acknowledges that, in some circumstances, certain services may be centrally acquired for the use of several establishments. In such cases, a detailed analysis of the use by each of establishment would be unduly burdensome so, in practice, approximations are often used.[65] It would, therefore, be necessary to establish a set of internationally agreed rules concerning acceptable methods of approximation for each type of service. Administrations will also have to consider the potentially dramatic increase in the number of internal transactions that have to be audited to prevent avoidance and evasion.[66] If not managed carefully, the recharge method could have the effect of dramatically increasing compliance and collection costs. This would be a very ambitious undertaking indeed.

Ultimately the OECD stops short of recommending a single approach. Instead it views that each approach will have its own benefits in different

[63] ibid, 47.
[64] ibid, 57.
[65] ibid, 60-61.
[66] ibid.

circumstances, and that different approaches can be combined when appropriate.[67] Given the above discussion, it seems that the recharge method is the most accurate way of determining destination in a VAT context. It thus comes as no surprise that it is favoured by Devereux and de la Feria.[68] A number of lingering issues have been mentioned but they are, at least theoretically, possible to resolve. Yet, it is submitted that it may not be possible to straightforwardly apply this to the DBCFT.

At first glance, it appears that there is no structural issue which prevents the recharge method being applied to the DBCFT. Like in a VAT context, following the internal recharge arrangements of a multinational allows tax authorities to track where services and intangibles end up being used, and hence where the 'true' destination lies. Nonetheless, it is argued that, on closer inspection, one can see that in the context of a direct tax, the recharge method is vulnerable to manipulation and could lead to significant avoidance. This can be seen by considering some variations of the following example: X sells an intangible to A, and the intangible is used in A's establishments in jurisdictions B and C. The internal recharge method allows authorities to see the real destination of the intangible, as well as how much of the cost each establishment is responsible for.

While this approach gives the multinationals the possibility to manipulate or misstate the internal recharge figures, in the context of VAT, there is no incentive to do so. The credit invoice method means that a business is charged VAT on each purchase it makes, but businesses are usually able to claim a credit or deduction for the VAT paid so long as the purchase was a business input. Hence, it is only the final consumer that actually pays the tax. This reflects the fact that VAT is a tax on consumption rather than general spending. Manipulating the figures to make it appear that the destination of an intangible is different from its actual location would, therefore, have no tax consequences for businesses. Yet, this may not be true in all situations under the DBCFT. To begin with, in the second version of the tax,[69] X pays no tax on the export, but the customer is unable to deduct the cost of the import from its tax base. As mentioned above, the tax operates under the subtraction-based method so businesses will be liable to pay the tax. As a consequence, if there is a way to manipulate the internal recharge mechanism to give the impression that the destination of an import is a low tax jurisdiction,

[67] ibid, 48. For example, the direct-use method is said to be particularly effective where the use of the service by one or more establishments is obvious.

[68] Devereux and de la Feria, (n 7) 17.

[69] This is the version where the customer pays no direct tax on the import but is unable to deduct the cost of the import from its tax base.

businesses may take such opportunity.[70] Under the second version of the tax, the non-deductibility of imports in all jurisdictions other than that of the seller means that an MLE is unable to shift its taxable profits in the same way it would under the source-based system.[71] Yet, it is possible to conceive of situations where manipulating the destination under the recharge method would result in more favourable treatment.

The first instance is where the multinational has an establishment in the same jurisdiction as the seller. If the internal recharge figures are manipulated to make it appear that the destination of the transaction is the jurisdiction of the seller, it would not be treated as an import. It would, therefore, be treated as deductible, resulting in lower tax liability. As mentioned, the OECD points out that many services, such as accountancy or legal services, are acquired by one establishment on behalf of the wider group; hence, it would not be difficult for an MLE to acquire such services in the same jurisdiction as the service provider and manipulate the recharge figures so that most, if not all, of the cost is attributed to the same jurisdiction. This problem would be exacerbated further if the service provider is also an MLE because the customer would then be able to choose the jurisdiction with the lowest tax rate. It is true that the provider may resist such an arrangement because, if the transaction is not characterised as an 'export', it is included in their tax base.

A few points can be made about this. Firstly, from a practical perspective, it is perfectly possible that in such a situation the customer may have the market power to insist on such an arrangement. In any case, it is likely that the formal destination of the services would become a bargaining chip in negotiations. This is surely undesirable. Secondly, the tax outcome in such a situation is heavily dependent on how each system treats different types of establishments. I will return to this point further below, but, for now, the problem can be demonstrated by using a simple example. In the situation where both parties are MLEs, it is possible that the establishments of each MLE may be characterised differently depending on exactly what form they take. To develop the example above, suppose that X has an establishment in jurisdiction B (B1) alongside A's office there (B2). If jurisdiction B did not, for whatever reason, recognise the existence of B2 but did recognise the existence of B1, the jurisdiction may view the transaction as being from jurisdiction B to jurisdiction C. This could be the case even if the purchaser's internal recharge figures suggest it is B2 which is using the service or intangible.

[70] As mentioned, tax authorities may seek to audit these figures, however, this will not lead to all manipulations being spotted. Further, where services are acquired by one establishment for the benefit of all businesses may legitimately locate the import of such services in one branch.

[71] Devereux and de la Feria, (n 7).

The consequence would be that jurisdiction B views the transaction as an export and so does not subject it to tax, but jurisdiction C does not view the profits of B2 as being subject to C's tax jurisdiction. The profits of B2, and the transaction between B1 and B2, would therefore go untaxed. Different results follow if it is B1 that is not recognised; jurisdiction B would view the transaction as being between A and B2 and so an import and non-deductible. The profits of B1 would not be taxed in either jurisdiction A or B, with the result that whilst B2 is taxed when it shouldn't be, B1 is not taxed when it should be.

If the first version of the DBCFT is adopted, the above analysis applies. Nevertheless, there is a more basic problem. In the original example, where only the customer is an MLE, manipulation of the internal recharge figures could straightforwardly be used to have the destination of the transaction in the most tax favourable jurisdiction.[72] Further, if the chosen destination was not the jurisdiction of the supplier, the supplier would have no reason to protest.

There is one further potential problem that is left unexplored by the literature on the DBCFT. While the authors say that either version of the tax could be adopted and that both versions are economically equivalent,[73] they do not say whether all jurisdictions must adopt the same version. If not, there is a further opportunity for avoidance as multinationals can alter their behaviour as appropriate. Suppose jurisdiction B chooses to implement the second version of the tax whereas jurisdiction C chooses to implement the first version. Branch B is an exporter with little taxable profits, and branch C sells primarily to the domestic market so has significant taxable profits. If a service is imported and used by both establishments, it may be advantageous to manipulate the figures so that the destination of the import appears to be jurisdiction B. As B's tax liability is connected to its profits, B will owe little tax. In jurisdiction C on the other hand, the same amount of tax will be levied, regardless of the branch's profits. If branch B has domestic sales of 50, labour costs of 20 and the import costs 40, its taxable profits will be 30. Assuming a tax rate of 10%, it will have a total tax liability of 3. If C has domestic sales of 120, labour costs of 20 and the import costs 40, it will have taxable profits of 60. Assuming a 10% tax on the import *and* the branch's profit, it will have a total tax liability of 10 (6+4). This may appear to be a convoluted route for a multinational to go down, and can be easily prevented by having all jurisdictions adopt the same version of the tax. Whether such consensus would actually be possible may come

[72] As stated above, this analysis is less likely to apply to businesses as it seems more likely that final consumers rather than businesses would face this version of the tax.

[73] Auerbach, Devereux, Keen, and Vella, (n 10) 29.

down to the preferences of each state and their existing tax structures. It certainly shouldn't be taken for granted that consensus could easily be achieved.

Hence, whilst the proponents of the DBCFT are right to argue that the tax eliminates the main methods of avoidance under the source-based system, this is not the whole picture. A lack of detailed discussion of the internal recharge mechanism, particularly in connection to branch mismatch arrangements (see Part II section C), means that the there is no recognition of the fact that this mechanism may not be suitable for the DBCFT.[74] It appears that formalism still exists in the proposed system, albeit regarding imports rather than profits.

2. Efficiency and Competition

Given these conclusions, the arguments outlined above in relation to efficiency and competition do not necessarily hold. In addition to providing an incentive to manipulate internal recharge figures, the DBCFT may also provide an incentive to structure transactions in particular ways to minimise tax liability. It flows that there might also be an incentive for countries to compete. It is true that different tax rates may not act as incentives in the same way as they would under the source-based system, but states may compete in other ways. For example, a state may choose to create favourable conditions for exporting establishments or may choose not to recognise the existence of certain branches. It, therefore, appears that the three core problems of formalism in a source-based system are still present under the DBCFT.

B. Branch mismatch arrangements

As mentioned, one of the key issues not discussed in any of the DBCFT literature is that of branch mismatch arrangements. The keen-eyed reader may have spotted that, whilst the OECD's VAT/GST report often makes reference to the 'establishments' of a multinational, there is surprisingly little detail on what this means. Footnote 24 says:

> For the purpose of these Guidelines, it is assumed that an establishment comprises a fixed place of business with a sufficient level of infrastructure in terms of people, systems and assets to be able to receive and/or make supplies. Registration for VAT purposes by itself does not constitute an establishment for the purposes of these Guidelines. Countries are encouraged to publicise what constitutes an "establishment" under their domestic VAT legislation.[75]

[74] Devereux and de la Feria, (n 7) 17; Auerbach, Devereux, Keen, and Vella, (n 10) 79.
[75] OECD, (n 6).

The working definition for the purposes of that report is of little importance in the present context. What is important, however, is the implicit acknowledgement that different countries may have different rules about what constitutes an 'establishment'. The problem will be laid out more fully below, but, in short, the issue is that jurisdictions often have different rules about how to characterize establishments in their territory resulting in a mismatch. Unfortunately, because of space limitations, this issue cannot be given the full attention it deserves here, so the rest of this paper will focus on the basics, and how this relates to the discussion about tax.

The OECD report on branch mismatch arrangements[76] came after a wider report on hybrid mismatches that addresses a range of issues including, inter alia, the characterisation of financial instruments.[77] It should be remembered that whilst the issue of branch mismatch arrangements is more obviously related to the destination principle, the following discussion may be just a small representative sample of the wider issues. Firstly, there is an overlap between the branch and hybrid mismatches because both can lead to the same problems of competition and efficiency, and many structures discussed in the branch mismatch report can also be found in the wider report on hybrid mismatches.[78] Nevertheless, branch mismatch arrangements remain distinctive. The OECD explains that, whilst hybrid mismatches generally are the product of inconsistencies because of different treatment of entities or financial instruments across jurisdictions; branch mismatches arise from the way the head office and the branch account for a payment made to or from a branch.[79] It therefore seems that taxpayers themselves can be just as much of a cause of the problem as the tax authorities, giving rise to avoidance and evasion opportunities.

There are three outcomes that may arise from branch (and hybrid) mismatch arrangements: (a) D/NI: "the payment is deductible under the rules of the payer jurisdiction but not included in the ordinary income of the payee"; (b) DD: "where the payment triggers two deductions in respect of the same payment"; and (c) Indirect D/NI: "where the income from a deductible payment is set off by the payee against a deduction under a hybrid mismatch arrangement".[80]

In total, there are five broad categories of arrangements that can lead to one of these outcomes. Unfortunately, space precludes discussion of all of these

[76] OECD, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (OECD Publishing 2017).

[77] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* (OECD Publishing 2015).

[78] OECD, (n 76) 10-11.

[79] ibid, 9-10.

[80] OECD, (n 77).

structures, so the rest of this paper will focus on the first two. These arrangements have been chosen because they are the most easily applicable to the DBCFT. The five categories are the following:

a. Disregarded branch structure. Under this structure, the jurisdiction of the headquarters (the residence jurisdiction) treats a payment as being made to a foreign branch and exempt from income. The branch jurisdiction, however, does not recognize the existence of the branch and so does not collect any tax. There are a range of ways in which this could arise.[81]

b. Diverted branch payment. This payment has the same structure as a disregarded branch, but the mismatch arises because of a difference in laws for the attribution of payments. Hence, even where the branch jurisdiction recognises the existence of the branch, if each jurisdiction treats a payment as if made to the establishment in the other neither will levy any tax. The residence jurisdiction will treat the payment as if it was made to the branch and hence deductible from the head office's income, whilst the branch jurisdiction will treat the payment as if it was paid to the head office and hence not included in the branch's income.[82]

c. Deemed branch payment. This mechanism takes advantage of rules which allow taxpayers 'to recognise a deemed payment between two parts of the same taxpayer'. Where there is no corresponding adjustment in the net income of the two entities to take the effect of this payment into account, internal mismatches can arise. The OECD gives the following example to help demonstrate this arrangement: "A Co supplies services to an unrelated company (C Co) through a branch located in Country B. The services provided by the branch exploit the underlying intangibles owned by A Co. Country B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arms-length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch). Meanwhile, the services income received by the

[81] ibid, 14-15.
[82] ibid, 15-16.

branch is exempt from taxation under Country A law because of an exemption or exclusion for branch income in Country A".[83]

d. DD branch payments. Such payments occur when one payment results in deductions in two different jurisdictions. The OECD outlines two ways in which such mismatches may arise. The first is where the residence jurisdiction provides the head office with an exemption for branch income while permitting it to deduct the expenditures attributable to the branch. If the branch jurisdiction also allows the taxpayer to claim a deduction for the same expenditure, a mismatch can arise.[84] The second way in which DD branch payments can arise is in situations where the residence jurisdiction considers all the income and expenditure of a taxable branch for tax purposes.[85] The main way of this occurring is when "the branch is permitted to join a tax group or there is some other mechanism in place in the branch jurisdiction that allows expenditure or loss to be offset against income derived by another person that is not taxable under the laws of the residence jurisdiction".[86]

e. Imported branch mismatches. Here, the mismatch arises where an entity with a "deduction under a branch mismatch arrangement offsets that deduction against a taxable payment received from a third party.[87] This results in an indirect D/NI outcome.

Each of these structures allows taxpayers to manipulate the source principle by exploiting the different treatment of the principle across different jurisdictions. In particular, the first two arrangements give taxpayers the opportunity to hide part of their taxable profits by locating branches in strategic locations where the source principle treats payments as being made to the head office. We, therefore, seem to have the same problem of formalism seen elsewhere. Of course, taxpayers are not entirely to be blamed for these mismatches as they have no control over the tax laws of the states in which they operate but are also not completely innocent. Using the example of diverted branch payments, the OECD points out that the mismatch could be eliminated if the taxpayer was to take the relevant payment into

[83] ibid, 16-17.
[84] ibid, 17.
[85] ibid.
[86] ibid, 16-17. See the example on pages 17 and 18 of the Guidelines more details.
[87] ibid, 18-19.

account in either the residence or branch jurisdiction.[88] Businesses will naturally make the decision whether to open a branch in a foreign jurisdiction on a variety of commercial factors and it would be foolish to argue that taxpayers are actively and aggressively pursuing tax avoidance opportunities in this way. Nevertheless, given that there is empirical evidence[89] showing that tax can and does have some influence in the decision-making processes of businesses, we should acknowledge that the arrangements just described have the potential to be a problem. This is even more so if they apply in a DBCFT context, as the OECD's proposed solutions may not be suited to a destination-based tax.

Before considering the solutions, it is important to understand how each arrangement would work in a DBCFT context. Given that imports are the effective subject of the tax, the discussion must revolve around them rather than payments and profit more generally. Hence, with regard to the disregarded branch structure, we are considering the situation where a branch pays for an imported good or service, but the branch jurisdiction does not recognise the existence of the branch. This means that, under the second version of the DBCFT, its profits (from which there would be no deduction for the import) are not taxed, so there is no effective tax on the import. As the residence jurisdiction views the branch as a separate taxable entity, the tax authorities do not include the branch's profits in its calculation of the head office's profits, and so the import is not taxed there either. Under the first version of the DBCFT, the situation may be more complicated because, even though the branch jurisdiction would again not recognise the existence of the branch, it is unclear what the effect of this would be in the context of a tax levied directly.

With regard to services and intangibles, the problem discussed in the previous section would again be relevant. Assuming, however, that the internal recharge method is a workable solution in the DBCFT context, and that the destination of all products could be ascertained, the question changes on how imports should be defined. If imports are defined by reference to their physical location or where they are *actually* used, there would be no problem in identifying the jurisdiction which should tax the import. If, on the other hand, imports are defined by reference to where they are *legally* considered to be used, there may be more of a problem. As the branch jurisdiction (the jurisdiction of actual use) does not recognise the existence of the branch and attributes all its activities to the residence jurisdiction, it will not recognise the import and therefore would not tax it. Furthermore, if the residence jurisdiction does recognise the existence of the branch, it will surely view the import as being one to the branch jurisdiction and

[88] ibid, 10.

[89] Auerbach, Devereux, and Simpson, (n 5) 855.

will not tax the import either. The situation could be complicated further if the two jurisdictions take different approaches on the characterization of imports. This issue clearly needs to be considered further.

The problem of the diverted branch payment can also arise in the DBCFT context. Under the second version of the DBCFT, if the branch jurisdiction attributes a payment to the residence jurisdiction and vice versa, the taxable profits in both jurisdictions will be lower, meaning that the effective tax on any imports will also be lower. Under the first version of the tax, the businesses' profits are not related to the amount of tax payable and are instead levied on the value of the import. Hence, a mismatch in the attribution of branch payments will have no effect on tax liability. But, if we instead consider the possibility of 'diverted branch imports' where there is a mismatch in the rules for determining the destination of an import, a similar problem will arise.

It should be said from the outset that the solutions offered by the OECD are not perfect and will not eliminate the problem even in a source-based context. It is inevitable that different jurisdictions will have different rules, so the OECD's recommendations are merely an attempt to minimise the damage such mismatches can cause. Recommendation 1 of the OECD report suggests that:

> [J]urisdictions that provide an exemption for branch income should consider limiting the scope and operation of this exemption so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction are properly taken into account under the laws of the residence jurisdiction.[90]

This recommendation is intended to address all five mismatch arrangements, rather than just the two being described in detail here. Nevertheless, it must be the starting point for the present discussion as the OECD sees this as the default and preferable approach because of a number of advantages it has over the other recommendations. Such advantages include its applicability to a wide range of arrangements and the comparative ease with which the head office can identify the payment that gives rise to the mismatch.[91] The report points out that there are a number of ways in which this could be successfully implemented in a source-based system, including by "requiring that any payment, which is derived by a resident taxpayer and not subject to tax in the branch jurisdiction, be brought into charge

[90] OECD, (n 77) 24.
[91] ibid, 24 and 58.

to taxation in the head office [and] limiting the branch exemption to the amount of net income actually brought into the charge to tax by the branch".[92]

Recommendation 2 of the OECD report deals with the issues of branch mismatch arrangements and diverted branch payments.[93] As the two issues are very similar in structure, the following discussion applies to both, unless stated otherwise. In respect of these two mechanisms, the OECD suggests that the "payer jurisdiction should deny a deduction for a payment that gives rise to a D/NI outcome"[94] to the extent that the outcome is the result of one of these two mechanisms.

As mentioned in Part II section B(1), the OECD admits from the outset that these recommendations, as well as others that are contained in the report, are unlikely to provide a complete solution to the formalism of the system, even where the tax is based on 'source' rather than on 'destination'. Proponents of the DBCFT must show either that the solutions will have at least some effect where corporations are taxed in accordance with the destination principle, or that alternative solutions exist. Space prevents full examination of the issue here, but prima facie it appears that there may be some problems in straightforwardly applying these solutions to the DBCFT. Such difficulty is simply because these solutions focus on payments rather than imports. Whilst it may be possible to adapt the OECD guidelines, a number of issues would have to be resolved, especially considering the discussion above on MLEs. Would the residence jurisdiction view the transfer as an import, despite the fact that the branch jurisdiction would not view it as an export? Would the headquarters have to pay an arms-length price, even though the branch jurisdiction does not recognise the existence of any 'external'[95] transaction? More generally, how are the headquarter to be identified, and what mechanisms could be put in place to minimise avoidance opportunities? How would any solutions prevent the manipulation of destination where the transaction involved services or intangibles? All these questions may have answers, but they should be fully explained and debated. As far as the author is aware, Devereux and others have not yet explored the problem of branch mismatch arrangements, let alone the wider issue of hybrid mismatch arrangements. We are therefore a long way from having the answers that we need.

III. Conclusion

The formalism in the current sourced-based corporate tax system has led to a number of problems which are clear for all to see. The proponents of the

[92] ibid.
[93] ibid, 27.
[94] ibid, 27.
[95] In example, transactions between two independent persons.

DBCFT put forward a strong case that their model will eliminate many of the problems faced by the source-based system. Despite their proclamations, much of their analysis has come from an economic rather than a legal perspective. This paper has sought to reveal the formalistic aspects through a legal analysis of the DBCFT by exploring just two of the problems related to destination which have received little if any attention in the literature discussing the tax. Further, it is far from obvious that any of the existing solutions to these problems can be implemented effectively in a DBCFT context. Others may still wish to argue that, despite these problems, the DBCFT is still preferable to the current source-based approach. The author does not wish to make any comment on this, but it is clear that, if the DBCFT was ever to be implemented, the formalism described above and its associated problems would have to be addressed.