Is the Destination-Based Cash Flow Tax Easily Gamed?

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Introduction

• DBCFT robust to gaming through:
  – Transfer Pricing
  – Placing IP in low tax jurisdictions
  – Debt shifting
  – Inversions

• No mean feat!
  – NB all substantive BEPS actions

• Lingering doubt

• Other strategies suggested
Transfer Pricing

• 2 methods of collection for cross-border B2B
  a. Collect on import and on sale to consumer
  b. Ignore import and collect on sale to consumer

• E.g.
  – CoA, in State A, sells goods to CoB, in State B, for 100
  – CoB sells goods to final consumers in State B for 120
  – CoB has no costs other than purchase of goods
  – Tax rate in State B is 25%
## Transfer Pricing

<table>
<thead>
<tr>
<th></th>
<th>Transaction value</th>
<th>Method 1</th>
<th>Method 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Co A sells to Co B</strong></td>
<td>100</td>
<td>25</td>
<td>/</td>
</tr>
<tr>
<td><strong>Co B sells to consumers</strong></td>
<td>120</td>
<td>5*</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total tax collected in B</strong></td>
<td>/</td>
<td>30</td>
<td>30</td>
</tr>
</tbody>
</table>

* (120-100)*25%
Transfer Pricing

If adopted universally

- Manipulation of TP would not change overall tax paid
- Light Blue: price set at 0; Dark Blue price set at 120

<table>
<thead>
<tr>
<th></th>
<th>Price</th>
<th>Tax: Method 1</th>
<th>Tax: Method 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Import</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Sale to domestic consumer</strong></td>
<td>120</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total tax liability</strong></td>
<td>-</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td><strong>Import</strong></td>
<td>120</td>
<td>30</td>
<td>0</td>
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Transfer Pricing

If adopted unilaterally

• TP manipulation possible but **NOT** to detriment of DBCFT jurisdiction
• Problems for other jurisdictions **exacerbated**
**Transfer Pricing**

*Exports – incentive to overprice*

**DBCFT**

Sub 1 → Sub 2

20 or 120?

**Non-DBCFT**

Sub 2 → Consumers

120

Goods cost 20 to produce, sold to consumers for 120
10% rate in both jurisdictions

Export exempt, indifferent to intra-group price

If intra-group price:

- 20 Sub 2 makes 100 profit (10 tax)
- 120 Sub 2 makes 0 profit (0 tax)
Transfer Pricing

**Imports – incentive to underprice**

Goods cost 20 to produce, sold to consumers for 120
10% rate in both jurisdictions

If intra-group price:
- 20 Sub 1 makes profit of 0 (0 tax)
- 120 Sub 1 makes profit of 100 (10 tax)

- Ignore intra-group sale (whether 20 or 120)
- Tax sale of 120 to consumers (12 tax)
Locating IP in low tax jurisdiction

- Profits *cannot* be shifted *out of DBCFT jurisdiction* through royalties paid to affiliates in non DBCFT jurisdiction
- Profits *can* be shifted *out of non-DBCFT jurisdiction* through royalties paid to affiliates in DBCFT jurisdiction
- Incentive to locate IP in DBCFT jurisdiction
Debt Shifting

• MNEs *cannot* shift profits *out of DBCFT jurisdiction* using debt
• MNEs *can* shift profits *to DBCFT jurisdictions* as interest will not be taxed
• Incentive to place debt in affiliates in non-DBCFT jurisdictions
Other strategies

• Is DBCFT perfectly robust to gaming strategies? (Probably) no tax is.

• Relative question – is it more robust than other systems?
  – Current systems undeniably weak

• *Strategies relying on direct sales from foreign entities to domestic consumers*
  – E.g. Sell goods to overseas sub which sells directly to domestic consumers
  – Enforcement issue – same for VAT systems around the world
  – Current work on using technological developments (e.g. using financial institutions or electronic identification devices)
Other strategies

• **Strategies based on fraud**
  – E.g. mislabel domestic sales as exports
  – Enforcement issues
  – Not gaming – evasion/criminal activity

• **Strategies to use losses if not fully refunded**
  – A case of making system work rather than gaming
Profits **cannot** be shifted **out of DBCFT jurisdiction** through royalties paid to affiliates in non DBCFT jurisdiction
Profits can be shifted out of non-DBCFT jurisdiction through royalties paid to affiliates in DBCFT jurisdiction.

Incentive to locate IP in DBCFT jurisdiction.
Debt shifting

Adopted unilaterally

MNEs cannot shift profits out of DBCFT jurisdiction using debt

DBCFT

Non-DBCFT

Sub 1

Loan

Interest

Sub 2

No Deduction

Tax
Debt shifting

- MNEs *can* shift profits to DBCFT jurisdictions as interest will not be taxed
- NB incentive to place debt in affiliates in non-DBCFT jurisdictions

![Diagram showing debt shifting between DBCFT and Non-DBCFT jurisdictions]