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Introduction

The destination-based cash flow tax (DBCFT), described further below, is intended to replace a tax on corporate income or profits. This paper discusses how a DBCFT, if adopted by one or more states, would fit with existing double tax treaties.[1] Given that the form of double tax treaties is based on the assumption that both contracting states operate a traditional income tax system[2] and given that a DBCFT is economically equivalent to a VAT combined with a reduction in payroll taxes, it is not surprising that, as the discussion below shows, treaties are poorly equipped to accommodate a DBCFT.

The treatment of a DBCFT under a double tax treaty depends crucially on whether a DBCFT is within the scope of the "taxes covered" provisions which are typically included in tax treaties, and in relation to which the various provisions of the treaty are intended to operate. The discussion therefore proceeds by reference to three questions:

1. Is a DBCFT within the scope of the taxes normally covered by double tax treaties?
2. What are the implications under the treaty of a DBCFT, both in the case where (i) a DBCFT is not in scope of the treaty's "taxes covered" and also (ii) in the alternative situation where a DBCFT is in scope?
3. What are the key policy considerations, including (i) for states with a DBCFT and (ii) for states operating a traditional corporate income tax?

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[1] References to double tax treaties in this article are to comprehensive double tax treaties based on the OECD Model Tax Convention on Income and Capital (OECD Model) and similar models.
[2] This is of course reflected in the title of the OECD Model – Model Convention with Respect to Taxes on *Income* and on Capital – and in treaties enacted by reference to that model, such as the US-UK double tax convention "For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on *Income* and on Capital Gains" (emphasis added).

The discussion is pursued primarily by reference to the situation where one state introduces a DBCFT and a treaty counterpart state operates a traditional corporate income tax.

1. Is a DBCFT within the scope of the taxes normally covered by double tax treaties?

To address this first question, the discussion will first clarify the essential properties of a DBCFT and deal briefly with some important points on double tax treaties and treaty interpretation. To address the key principles that will be of general relevance, the discussion will consider the position by reference to the OECD Model, though some consideration is also given to the position under a specific treaty, namely the current US-UK double tax treaty. The reason for this choice is that the ongoing tax reform discussions in the US have included as one option the introduction of a DBCFT, highlighting the fact that the issue discussed here may be of potential relevance in the context of specific treaties, such as the US-UK treaty.[3] Of course, the precise form of a DBCFT as ultimately adopted in any one country may have a material influence on the analysis discussed here.

The nature of a DBCFT

It is beyond the scope of this article to set out a detailed explanation of the nature and properties of a DBCFT.[4] For present purposes, however, the essential features of a DBCFT may be summarized as follows:

A DBCFT has two basic components:

- The "cash flow" element - as its name implies, 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 made. 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 to most existing corporate tax systems, is that under cash flow taxation even capital assets that are typically depreciated over time are immediately expensed (i.e. deducted in full upon purchase)[5]. This also introduces a significant difference between the cash-flow tax base and measures of profit in financial statements.
- The "destination-based" element - the international setting introduces the second dimension of a DBCFT, relating to how a country determines the

[3] The DBCFT is often referred to in the U.S. as the "Border Adjusted Tax".
[4] A fuller discussion of the DBCFT, from which this summary is drawn, may be found in Alan Auerbach, Michael Devereux, Michael Keen and John Vella, Destination-Based Cash Flow Taxation, Oxford University Centre for Business Taxation, Working Paper 17/01 available at: http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf.
[5] This approach to capital assets means there is therefore no need for complex depreciation rules that are typically found under current systems, and no need to differentiate between different types of assets.

> component of a corporation's tax base falling within its particular jurisdiction. A DBCFT would be based on sales of goods and services in the country less expenses incurred in the country: so the "border adjustments" made under a DBCFT would mean that receipts from exports are not included in taxable revenues and imports are taxed.

A simple example may illustrate the basic operation of a DBCFT. Suppose a company produces goods in country A, employing labour at a cost of 60 and with costs of 40 on other domestic purchases. It sells goods to domestic consumers in A for 150, and also exports goods to country B that are sold in that country for 150. It therefore has a total profit, in cash flow terms, of 200. The DBCFT tax base in country A is calculated as domestic sales of 150 less domestic cost of 100: a total of 50. The DBCFT tax base in B is simply the value of the imports into B: 150. If the tax rate in A is 20% and that in B is 30%, then the firm's tax liabilities are 10 in A and 45 in B.

A DBCFT may be applied by reference to two alternative approaches – namely by reference to taxing cash flows on a 'R' base (i.e. taxing only "real" cash flows) or by adopting the broader 'R+F' base (taxing "real and financial") flows. Where the "R-base" is operated, any flows relating to borrowing and interest would be ignored in applying the tax. Under both bases, flows to and from shareholders, including dividends, would be excluded from the tax base.

It is also relevant to clarify that, in implementing a DBCFT, two major design options are available, namely implementing the tax as a reform to the corporate income tax or alternatively introducing a DBCFT in the economically equivalent form of a VAT, combined with tax relief for labour costs.[6] In either case, the tax would effectively fall on domestic spending from non-wage income, in particular on spending from economic rent. This is because, in either case, the introduction of the tax can be expected to raise domestic prices and domestic wages, relative to their values in the rest of the world (this could be achieved by a rise in the value of the domestic currency). The effect on prices is similar to the effect of a VAT; since only domestic spending is subject to tax, then the consumer price should rise relative to the price elsewhere. But, unlike VAT, the DBCFT would also give relief for domestic wage payments. This means that there needs to be no relative change in the values of prices and wages, and hence domestic wages should also rise.

However, there would be no change in the post-tax value of income from corporate profit (or possibly other non-wage income)_. As a result, the tax effectively falls on those who spend domestically out of non-wage income – and specifically out of taxed profit. Since the tax falls on domestic residents, then in principle, and unlike a conventional source-based corporation tax, there are no spillover effects on residents of other countries. As a result, there is in principle

[6] A DBCFT is intended to tax profit, and so gives relief for labour costs. An (economically equivalent) alternative to giving relief for labour costs is to reduce labour income taxes at the same rate – see further Alan Auerbach, Michael Devereux, Michael Keen and John Vella, Destination-Based Cash Flow Taxation, Oxford University Centre for Business Taxation, Working Paper 17/01, at p.18.

no need for treaties to deal with double taxation.[7] This argument applies equally to value added taxes, and is why in principle there is no need for a treaty to deal with double taxation of VAT. We discuss this further below.

A DBCFT therefore has a quite different base to traditional corporate income taxes that are levied in the country where a producer resides (residence) or where the production activities that give rise to profits are carried on (source).

Double tax treaties and treaty interpretation

In an international setting, double tax treaties have been used extensively by states as the primary mechanism to avoid the international double taxation that would otherwise arise from the competing claims of domestic tax systems. In that context, the intended role of the widely-applied OECD Model is to achieve common solutions and uniform approaches to avoid double tax.[8] It follows that the central function of treaties to avoid double tax is potentially defeated to the extent a tax falls outside the scope of double tax treaties . Double tax treaties have also had some role in preventing international tax avoidance, a role that has recently become more pronounced.[9]

It is also relevant to note that double tax treaties are essentially bilateral agreements based on reciprocity between contracting states. This means the perspective of individual states is of critical importance and also that there could be significant variation in what is included in any particular treaty and in the interpretation of the provisions in a treaty, depending on the local domestic law and constitutional position of a given state.

However, especially in the context of a DBCFT, it is worth exploring a little further what is meant by “double taxation”. Consider, for example, a company that is subject to corporation tax on its profit in the “source” country, but which is also liable to VAT in the place in which it makes a sale. As discussed further below, the OECD approach of ignoring indirect taxes in double tax treaties was historically due to the perceived limited incidence of double taxation from these other taxes. However, in the current era where such taxes are much more prevalent, the continuation of that approach is presumably based on the notion that indirect taxes (such as the modern-day VAT) do not fall on the owners of the business, but are passed on to consumers; as such they do not represent a

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[7] See the formal analysis in Alan J. Auerbach and Michael P. Devereux (2013) Consumption and cash-flow taxes in an international setting, Oxford University Centre for Business Taxation Working Paper 13/11, available at https://www.sbs.ox.ac.uk/faculty-research/tax/publications/working-papers/consumption-and-cash-flow-taxes-international-setting. The extent to which the tax falls on spending from other non-wage income depends on whether the prices adjustments take the form of an appreciation of the exchange rate, and if not, whether such income is indexed to prices. See also Alan J. Auerbach, Michael P. Devereux, Helen Simpson, Taxing Corporate Income, in: Institute for Fiscal Studies (Ed.), Dimensions of Tax Design: The Mirrlees Review (OUP 2010) at p.883.

[8] See OECD Model, Introduction, paragraph. 2

[9] Historically, the role of preventing tax avoidance has arguably been a secondary function of double tax agreements – though it has now been given greater emphasis following the OECD’s BEPS project – as, for example, in the work on Action Point 6 of the BEPS Action Plan.

second level of tax on the income of the company. But a large economics literature investigates issues of effective incidence. Among other things, this literature suggests that in a small open economy, a conventional source-based corporation tax is also passed on, in higher prices to consumers and lower wages to employees.[10] In this case, not only is there not double taxation of the business (or its owner), there is not even single taxation.

There appears to be an inconsistency, then, in the treatment of VAT and corporation tax. If both taxes are evaluated with respect to their effective incidence, then there may be no double taxation. However, it is complex to evaluate effective incidence, and there remains an academic debate on the incidence of corporation tax. That may push us towards considering only the formal incidence, of who is required to remit the tax. But in this case, we should not ignore VAT; indeed, businesses remit many, indeed most taxes.

These considerations already suggest that the nature of the existing treaty network is not necessarily consistent with economic analysis. Nevertheless, the issue in question here is a legal one of whether a tax which has similarities to both a corporation tax and a VAT is within the scope of double tax treaties.[11]

DBCFT and the OECD Model – the Scope Issue

As reflected in the articles of the OECD Model, the scope of double tax treaties is typically defined by reference to the "persons covered" (Article 1) and the "taxes covered" (Article 2). Given that a DBCFT is a new form of taxation and not a tax already applied by states, the key issue is whether a DBCFT is within the scope of Article 2.[12] This issue is fundamental to the operation of double tax treaties because taxes that are within the scope of Article 2 are dealt with under the treaty's "distributive articles", numbers 6-22, and under the elimination of double tax rules of Article 23.[13] However, if a tax is not within the scope of Article 2, those distributive articles and the treaty provisions on the elimination of double taxation are inapplicable[14] and the treaty becomes of limited relevance

[10] See Gordon, R.H. (1986) "Taxation of Investment and Savings in a World Economy", *American Economic Review* 76, 1086-1102.

[11] The difficulties explored here are not unique to the DBCFT but are also relevant to various new types of corporate taxes that are alternatives to the traditional corporate income tax – see for example, M. Tenore, "Taxes Covered": The OECD Model (2010) versus EU Directives, Bulletin for International Taxation, 6/2012 (volume 66) 162 and Vol. 45, Issue 5, 2017 Kluwer. Roland. Ismer and Christoph Jescheck, The Substantive Scope of Tax Treaties in a Post BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes, *Intertax* 45.5, 382.

[12] A DBCFT may be levied on individual taxpayers, including individual group companies within a MNE, but in this context the "residence" requirement imposed by Article 1 of the OECD Model would have little significance.

[13] The distributive articles of a double tax treaty are those individual articles that classify particular types of income (and capital) and in each case determine which of the states is required to restrict or withdraw the tax claims under its domestic law in order to avoid double taxation. See Klaus Vogel, On Double Tax Conventions, 2nd edition, Kluwer, 1990, paragraph 45 at p. 19.

[14] P. Baker, Double Tax Conventions, Sweet & Maxwell at 2B.01. Where relief for double taxation is not available under a treaty, taxpayers will need to rely on unilateral measures for the relief of double taxation, if available.

(although not wholly irrelevant, as discussed in the next section of this paper). The starting point for the analysis therefore concerns the status of a DBCFT under Article 2 of the OECD Model ("Taxes Covered").

Article 2 of the OECD Model – "Taxes Covered"

Article 2 is one of the shorter articles in the OECD Model and comprises four paragraphs which may be summarized as follows[15]:

- Article 2 (1) sets out the primary rule – the treaty applies to "taxes on income and on capital…irrespective of the manner in which they are levied". The Commentary to the OECD Model makes it clear that this scope is intended to be as wide as possible.[16]
- Article 2 (2) seeks to provide a definition of "taxes on income and on capital" but the guidance is not very helpful as it is circular, referring to "all taxes on total income…or on elements of income". The discussion in the Commentary is hardly more helpful given that it seems to be assumed that it is obvious what is a tax on income, though a clue is given by the explanation in the Commentary that the term "direct taxes" was thought to be "far too imprecise" and was therefore avoided.[17]
- Article 2 (3) enumerates the existing taxes (at the time of the signing of any particular treaty) to which the treaty is intended to apply.
- Article 2 (4) comprises a rule to ensure that certain changes to the tax systems of the contracting states after the treaty has been signed do not require the treaty to be re-negotiated. Provision is therefore made that the treaty is to apply to "any identical or substantially similar taxes" imposed after the signature of the treaty in addition to, or in place of, the existing taxes. There is also a requirement for the contracting states to notify each other of significant changes made in their tax laws.

Some treaties exclude the provisions contained in Article 2 (1) and (2) of the OECD Model, restricting the scope of the Article on taxes covered to the enumeration of existing taxes, together with the provision for subsequent changes (Article 2 (3) and (4) of the OECD Model). There are also treaties that do not include any specific list of taxes covered but rather include only the generic

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[15] The drafting of Article 2 has not changed materially since the first drafts of the provision were prepared in 1957 – see Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011, at pp. 16 and 43-44. That publication is based on the Ph.D. thesis of Patricia Brandstetter, The Substantive Scope of Double Tax Treaties - a Study of Article 2 of the OECD Model Conventions, available at http://epub.wu.ac.at/2019/ On Article 2 more generally, see also Michael Lang, "Taxes Covered" - What is a Tax According to Article 2 of the OECD Model? Bulletin for International Taxation, vol. 59 no. 6 (1 June 2005).

[16] Model Commentary to Article 2, paragraph. 1.

[17] See Model Commentary to Article 2, paragraph 2. The relevant background is explained in Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011, at p. 96 and note 368. The express reference to "direct taxes" contained in the earlier League of Nations Draft Model Conventions was not endorsed in the 1957 Draft Conventions. The Italian Delegate comments that the first paragraph of the draft article "adopts ... the terms 'taxes on income' and 'taxes on capital', thus dispensing with the less precise term 'direct taxes'."

definition.[18] However, the discussion below proceeds on the basis that the entire Article 2 is relevant. In that case, the first question to be addressed in relation to a DBCFT is whether it is a "tax on income" for the purposes of Article 2 (1).[19] As it is assumed to be most unlikely that a DBCFT would be included in any listing of existing taxes in Article 2 (3), it is also relevant to ask whether it might fall within Article 2 (4) if enacted by a state subsequent to the signing of a treaty to replace a traditional corporate income tax.

1.1 Article 2(2) of the OECD Model: What is an "income tax"?

As noted above, there is in the OECD Model little useful guidance on the nature of "taxes on income".[20] The only real help in the OECD Model comes from neither Article 2 nor the accompanying Commentary but from the structure of the Model itself. This is because Articles 6-21 of the OECD Model comprise "Chapter III – Taxation of Income" so arguably the nature of those articles indicates the items which may be subjected to income tax.[21] However, this is hardly a definitive test or criterion of what is to count as a tax on income. The uncertainty is concerned primarily with nature of "income" as the term "tax" is relatively much less problematic as regards the issues debated here. [22]

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[18] For a fuller discussion of the wide variation in approaches adopted in existing tax treaties, see Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association 2016 at pp. 166-7.

[19] Taxes on capital (which may include taxation of capital appreciation) are dealt with in Article 22 of the OECD Model and generally constitute complementary taxation of income from capital. The DBCFT is not designed to tax capital (including capital constituted by property) per se and accordingly the question of what capital taxes are within the scope of the OECD Model is of little relevance to the position of a DBCFT. The distinction between taxes on income and taxes on capital is considered in Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association 2016 at pp. 179-182.

[20] However, it is worth noting that the Commentary to the OECD Model refers to the function of Article 2 as including the intention "to ensure identification of the Contracting States' taxes covered by the Convention" - See Model Commentary to Article 2, paragraph 1. This implies that in construing the reference to "taxes on income" a treaty meaning of that term (which could operate as such a criterion for identifying domestic taxes to be covered by the Convention) should be applied, rather than simply defaulting to a domestic law meaning in accordance with the interpretation rule in Article 3 (2).

[21] According to Klaus Vogel, the context of the distributive rules of Articles 6-22 of the OECD Model reveals all the items which, according to the Model, may be subjected to income tax – See Klaus Vogel, On Double Tax Conventions, 2nd edition, Kluwer, 1990, paragraph 30 at p. 89.

[22] On the definition of "tax", the absence of a definition of the term seems to require recourse to a domestic law meaning in accordance with the rule in Article 3 (2) of the OECD Model. It is assumed in any event that a DBCFT would qualify as a "tax" given that it would possess the attributes of requiring a compulsory payment or charge, would be levied by an organ of government and for public purposes, and would not be tied to any benefits received by the payer. The critical issue is therefore whether it ranks as a tax "on income". For a fuller discussion of the notion of tax in international tax law, see generally Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association, 2016 at pp. 155 – 223. That discussion also includes a specific consideration of the notion of tax for the purposes of Article 2 of the OECD Model (see at pp. 169 – 174) which considers the attributes of a "tax" referred to above.

Domestic tax law tends to be equally unhelpful. The position in the UK seems typical:

> "The Income Tax Acts nowhere to define "income" any more than they define "capital"; they describe sources of income and prescribe methods of computing income but what constitutes income they discreetly refrain from saying…." Lord Macmillan in Van den Berghs Ltd v Clark.[23]

The absence of clear tests complicates the task of determining whether a DBCFT is a tax on income. The matter is considered below from various perspectives. The starting point will be to address first principles, including the nature of "income" as an economic concept and the usefulness of any distinction between direct and indirect tax. Consideration is then given to the features of a DBCFT that might seem potentially at odds with the status of that tax as a tax on income. Lastly, there is a discussion of the degree to which a DBCFT is congruent with the OECD Model, applying the argument referred to above that Chapter III of that Model represents a good indication of the items of income that are intended to fall within the scope of the treaty and which are therefore indicative of the relevant nature of a tax on income for the purposes of the treaty.

(i) First Principles – The Nature of Income and the Direct-Indirect Tax Distinction

The nature of "income"

Formative work on the nature of income as an economic concept in the context of tax systems was carried out in the late nineteenth and particularly the early twentieth century, as income taxes were beginning to be introduced or expanded to pay for the first world war.[24] It was at this time that R.M Haig developed the basis of what is now often referred to as the Haig/Simons notion of comprehensive income.[25] Haig built on earlier broad-based notions of income, such as Professor Irving Fisher's "Income consists of benefits"… "A flow of benefits during a period of time is called income",[26] with the general recognition of the need for a defined notion with a common unit for measurement and evaluation, namely money:

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[23] [1935] A.C. 431 at 438

[24] For example, from 1913 the 16th Amendment to the U.S. Constitution allows the taxation of income. See generally G. von Schanz, Der Einkommensbegriff und die Einkommensteuergesetze, 13 Fin Arch 1 (1896) and R.M Haig, The Concept of Income – Economic and Legal Aspects (included at pp. 1-28 of volume, Federal Income Tax, a series of lectures a Columbia University in December 1920. (Columbia University Press, 1921). The later work of Simons has also proved influential – see H. C. Simons, Personal income Taxation: The Definition of Income as a Problem of Fiscal Policy (1950). The history of the income concept among tax and fiscal theorists is explored in John R. Brooks, The Definitions of Income, 71 Tax Law Review (forthcoming).

[25] R.M Haig, The Concept of Income – Economic and Legal Aspects (included at pp. 1-28 of volume, Federal Income Tax, a series of lectures a Columbia University in December 1920. (Columbia University Press, 1921)

[26] Irving Fisher, Elementary Principles of Economics, 1908, p.98 at pp. 2-3

> "Under this conception, income becomes the increase or accretion in one's power to satisfy his wants in so far as that power consists of (a) money itself, or, (b) anything susceptible of valuation in terms of money. More simply stated, the definition of income which the economist offers is this: Income is the *money value of the net accretion to one's economic power between two points of time*."[27]

The economic test of income was therefore whether a particular item increases the economic power of the recipient to command satisfaction-yielding goods or services. If it does, it is income.[28] This notion of "comprehensive income" remains very broad and might in addition to monetary income include, for example, an increase in the value of assets such as houses, paintings, chattels, etc. and the monetary equivalent value of services received such as free babysitting provided by a relative, inheritances, gifts, etc. However, the domestic law of states typically applies an appreciably narrower concept of income. Items such as gifts, legacies, unrealized gains, services rendered, etc. are typically excluded from the taxable measure of income. In addition, overseas income may be ignored, as under a territorial tax system. Withholding taxes are also routinely applied to gross income flows, i.e. with no deduction for expenses. There are also cases where "fictional" or notional income is taxed as in the case of CFC regimes and exit tax rules. None of these features seems to prevent the resultant taxes from being regarded as taxes on income even though they may fall well short of taxing by reference to "comprehensive income". There is therefore a gap between an economist's notion of income and what states actually do in taxing what they regard as income. This implies that resort to first principles provides at best a rather vague answer to the nature of "income" for the purposes of Article 2 (1).

Any argument that a DBCFT cannot be accepted as an income tax because it does not conform to a Haig-Simons notion of income is therefore clearly invalid, given the breadth of the Haig-Simons notion and the obvious general deviation from that "pure" notion of income in practice by domestic tax systems.[29]

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[27] R.M Haig, The Concept of Income – Economic and Legal Aspects (included at pp. 1-28 of volume, Federal Income Tax, a series of lectures a Columbia University in December 1920. (Columbia University Press, 1921), p. 7. Interestingly, Haig seems to have seen "accretion" income as a second best approach to the tax base and to have actually preferred consumption expenditure as a better measure of true income, though this was not the option chosen as it was considered unfeasible – see at pp. 2-5.

[28] R.M Haig, The Concept of Income – Economic and Legal Aspects (included at pp. 1-28 of volume, Federal Income Tax, a series of lectures a Columbia University in December 1920. (Columbia University Press, 1921), p.11.

[29] Vogel sees Schanz-Haig-Symons approaches to income as involving the widest interpretation of the notion of income, with the positive definition of "income" or "revenue" in national income tax legislation being appreciably narrower - See Klaus Vogel, On Double Tax Conventions, 2nd edition, Kluwer, 1990, paragraph 30 at p. 89. Also, it is concluded by Helminen that economic models such as those of Schanz-Haig-Symons are not decisive for tax law purposes – see Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association 2016 at p. 163.

Further, given the breadth and variation of the standards that are applied in practice by states in taxing what they regard as "income", it might be argued that the application of a DBCFT on a "net" base of receipts less payments (with the result it taxes increments or net benefits) is sufficient to create a presumption that it should be regarded as a form of tax on income (though subject to the consideration below of certain specific design features of the DBCFT).

Direct v Indirect Tax

One alternative approach is to explore the possible usefulness of the distinction between direct and indirect tax.

It is clear that, since the first use of comprehensive double tax treaties of the sort discussed here, they have been intended to apply to what are usually thought of as direct taxes but not indirect taxes.[30] This raises the question as to the nature of the distinction between the two and whether it might be helpful here. The distinction between direct and indirect taxes is old and essentially relates to whether a tax is levied on the person who it is expected will bear the tax (direct tax) or who will pass the effect of the tax on to others so that they bear the tax (indirect tax).[31] Thus, whilst a direct tax is intended to tax directly the person who bears the tax, the attributes of an indirect tax, such as a VAT, are broadly:[32]

- The intended effect is to tax the final consumer, but
- The tax is collected from intermediate suppliers and producers, not the consumer
- The tax is applied at each step in the relevant distribution/ sales chain

The distinction remains common in the field of taxation[33] and the distinction is also used extensively in EC law and world trade law.[34]

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[30] As is discussed further below, the decision to focus on "direct" taxes was taken as long ago as 1925 and, despite the somewhat disparaging reference in the current OECD Commentary to "direct taxes", historically such taxes do seem to have been broadly what was intended as regards the scope of double tax treaties.

[31] "Taxes are either direct or indirect. A direct tax is one which is demanded from the very person who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intuition that he shall indemnify himself at the expense of another; such are the excise or customs." - John Stuart Mill, *Principles of Political Economy*, Book V, Chap. 3 ("Of Direct Taxes"), first published 1848.

[32] See generally Chapter 6 of the book, Taxing Global Digital Commerce: A Study in Tax Law and Technology Change (A. Cockfield, W. Hellerstein, R. Millar and C. Waerzeggers et al; Kluwer, 2013). Chapter 6 also identifies a second way in which a VAT may be an indirect tax, i.e. due to the fact that the tax charge is levied on expenditure on consumption rather than on consumption itself.

[33] See for example the distinction between direct and indirect taxes made recently by the OECD in Addressing the Tax Challenges of the Digital Economy, Action1 – Final Report, OECD/ G20 Base Erosion and Profit Shifting Project, at paragraphs 41 and 42. Further, the distinction features extensively in the discussion of WTO law and the DBCFT – see Wolfgang Schoen, 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, January 2016.

[34] See further Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011 at p.96.

As set out in this way, the distinction violates one of the fundamental economic principles of the effective incidence of tax. That is, the effective incidence of a tax does not depend on who remits the tax. For example, a tax on the buyer of a good would have the same incidence as a tax on the seller of a good. And a tax levied on the wages paid by an employer would have the same incidence as a tax paid by the employee on the wage received. Yet, the distinction set out above appears to be that the incidence of a direct tax falls on the person who remits it, where this is not true of an indirect tax. Given that most income taxes are remitted by the employer, this seems an odd distinction.

In economic terms, the distinction is not significant.[35] For example, it is easily demonstrated that a tax on wage income (but not capital income) is equivalent in its economic effects to a tax on spending.[36] The key is the spending power in terms of goods and services that is possible with a given gross income. Both forms of tax drive a wedge between gross income and the goods and services that it can buy. It makes no difference in economic terms whether the tax reduces net income or increases the price of goods and services.

Putting these difficulties to one side, it might be argued that, although the distinction between direct and indirect tax is imprecise, a DBCFT is similar to a VAT and therefore cannot be an income tax as it is obviously widely acknowledged that a VAT falls outside the scope of comprehensive double tax agreements.[37] It is true that the properties of a DBCFT are very similar to those of a VAT, though with one major exception. That exception is the available deduction under a DBCFT for in-jurisdiction labour costs (but not, in effect, for "imported" labour costs, i.e. labour costs incurred outside the jurisdiction).

It is at least questionable whether this single difference transforms a DBCFT for the purposes of the "income" tax test from something that is obviously not included (a VAT) to a tax that is included (a tax on income). Further, an (economically-equivalent) alternative to giving relief for labour costs under a DBCFT is to reduce labour income taxes at the same rate as would otherwise have been relevant to the income against which any deduction would have been available.[38] If that approach were followed in the design and enactment of a DBCFT (i.e. so that the relevant DBCFT would mirror a VAT with the addition of a complementary reduction in labour income taxes) it would seem very difficult to

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[35] There may also be cases involving difficulties in determining whether a tax is an income tax or a turnover tax for the purposes of being covered by tax treaties – for example, see the discussion of the Hungarian case Kfv.I.35.103?2008/4 in Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association 2016 at p. 182.

[36] Strictly, this involves various restrictions, for example, the absence of pure profits or inheritance.

[37] See footnote 24 as regards the historical intention to this effect. For a contemporary confirmation that the OECD Model is clearly not intended to apply to indirect taxes see P. Baker, Double Tax Conventions, Sweet & Maxwell at 2B.10.

[38] See further the article at: http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf, at p.18.

resist the argument that a DBCFT is outside the scope of treaties on the basis it is equivalent to a VAT. This emphasizes the relevance of design choices in the enactment of any specific DBCFT.

It may therefore be concluded that, though the distinction between direct and indirect taxes falls a long way short of providing any clear test of exactly what a tax on "income" is for the purposes of Article 2 of the OECD Model, the parallels with VAT create a material impediment to a DBCFT being regarded as such a tax on "income".

(ii) Relevant Features of a DBCFT

There are certain features of the DBCFT that may be considered to be of special relevance to the question of whether or not it should be regarded as a tax on income – specifically, the "cash flow" basis and the treatment of exports and imports.

In relation to the cash flow base of the tax, it might be objected that, though a tax on a measure of increment, the cash flow basis (including full deductions for capital asset expenditure) is alien to accepted methods of arriving at proper measure of business income and so a DBCFT is *not* similar in kind to traditional corporate income tax. In consequence, it should not be regarded as a tax on income in the sense that that term has been applied by tax systems. However, such an objection is easily dealt with. Despite the "cash flow" label, it is likely that accruals concepts would be used to determine the appropriate measure of DBCFT income and costs.[39] Even if there were no use of an accruals methodology in the operation of a DBCFT, the use of a cash basis would arguably still represent an acceptable methodology to arrive at a measure of net income or gain. Individual tax systems may themselves tax income on a "received" basis or allow deductions on a "paid" basis (rather than on an accruals) basis. Further, the treatment of expenditure on capital assets under a DBCFT is not different in concept (but may be in degree) to the granting of tax depreciation allowances under existing tax systems.[40] For these reasons, objections based on how a DBCFT approaches the relevant measure of income or expenditure may be rejected.

A variation of this argument might be that a DBCFT is a tax on economic "rents" rather than nominal income per se and therefore cannot properly be regarded as a tax on "income". The effect of a DBCFT is to tax economic rents by virtue of the immediate expensing of capital assets, rather than, as in a traditional corporate income tax, depreciating them over time.[41] However, the immediate expensing

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[39] The reference to a "cash flow" element in a DBCFT has never been intended to preclude in all situations the use of an accruals (as opposed to strictly cash) basis of accounting.

[40] In the UK, for example, there are various capital allowance (tax depreciation) regimes that have applied at a first year rate of 100%, such as the Enhanced Capital Allowances given to energy saving and environmentally beneficial plant and machinery.

[41] For a more detailed explanation with a worked example, see Alan Auerbach, Michael Devereux, Michael Keen and John Vella, Destination-Based Cash Flow Taxation, Oxford University Centre for Business Taxation, Working Paper 17/01 available at:

of capital assets does not seem a sufficient point of differentiation to existing income tax systems to warrant a conclusion a DBCFT may not be regarded as a tax on income. Put another way, the concept of income for tax purposes does not seem so precise or circumscribed as to exclude the taxation of economic rents.

It might be argued that a DBCFT does not tax income from exports despite allowing deductions for the relevant in-country costs and accordingly the tax is not a tax on the "true" income of the taxpayer.[42] This also does not seem to be a strong argument. There is no requirement under existing tax systems that *all* income of a taxpayer must be taxed for a tax to be regarded as being a tax on income. Under existing tax systems, a variety of exemptions may apply depending on the source of the revenues (e.g. as under a territorial tax system) or the character of the income (e.g. as in an exemption for, say dividend income or non-business income received). Neither is it considered that the availability of a deduction for in-country costs relating to goods or services that are exported and therefore exempted from the DBCFT charge means that the tax cannot generally be regarded as a tax on income. This is because tax systems that are clearly regarded as taxes on income may similarly allow material deductions for expenditure relating to the earning of tax-exempt income.[43]

An argument based on the treatment under a DBCFT of imports, namely that the treatment (taxation) of imports cannot be reconciled with the characterization of DBCFT as an income tax, raises more difficult issues. By way of recap, in the case of imports of a taxed business, a DBCFT either taxes imports and gives a deduction for the cost of imports, or alternatively ignores imports altogether – neither taxing them or giving a business deduction for the cost of imports. (The two alternative approaches yield the same result in economic terms, at least if the business is not making a taxable loss, and the DBCFT does not permit those losses to be used immediately.)

From the perspective of the DBCFT being a tax on the importer, this seems inconsistent with the general approach of an income tax which would allow a deduction for costs. By contrast, a DBCFT, irrespective of which of the two alternative approaches is adopted, would not give a deduction for costs which reflect imports.[44] Any such argument based on the treatment of imports by a DBCFT is complicated because the relevance of the tax treatment of imports under a DBCFT will vary from taxpayer to taxpayer according to whether they import or not and according to the scale of importing in any particular case.

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http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf at pp. 10-11.

[42] A variation of the argument might be made to include also the failure to tax dividends and interest if the DBCFT is applied on a "R" basis as in that case financial flows (and therefore financial income) would therefore be excluded from the base of the tax.

[43] The OECD draws attention to this point in relation to interest deductions which relate to the financing of tax-exempt income its work on Action 4 of the BEPS Action Plan – see further, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report, OECD/ G20 Base Erosion and Profit Shifting project, OECD Publishing, Paris at pp. 11, 16.

[44] A variation of this argument might be made to include also the absence of a deduction for financial flows such as interest if an R basis of the DBCFT is applied.

In the situation where a DBCFT neither taxes imports nor gives a deduction for the related costs, it would be harder to argue against the point that no deduction is available. In such a case, any argument in support of a DBCFT being an income tax would presumably rest on the point that imports are targeted as non-deductible category for policy reasons and, in any event, that treatment does not prevent a DBCFT from being an income tax, just as existing tax systems may impose blanket bans on large items of cost (such as entertaining expenditure, fines, certain group support costs, etc.) on policy grounds without undermining their status as a tax on income.

It is also possible to consider the issue from a different perspective by focusing not on the absence of a deduction but rather by reference to the taxation of the import. It would seem difficult to characterize the tax charge on the import as being a tax on the *income* of that importer (to the importer, the import is a "cost" not an item of revenue). However, it might be argued that the tax is properly to be regarded as a tax on the seller – i.e. the exporter. In that event, however, the tax is a tax on gross revenues (i.e. with no deduction for the associated costs of producing the good or service exported) and such a tax, which might also be labeled a "turnover" tax, would normally be regarded as failing to possess the requisite feature of a tax on income.[45] (In comparison with the approach adopted in double tax treaties, there may also be a nexus issue, though this would be a separate issue to questions on the nature of the tax imposed.)[46] The tax treatment of imports under a DBCFT therefore presents material difficulties to the proposition that a DBCFT should be regarded as a tax on income.

(iii) Congruence of the DBCFT with the OECD Model

Finally, it is possible to evaluate whether a DBCFT should, or should not, properly be regarded as a tax on income by considering the structure of the OECD Model itself. This follows from the argument that the individual articles contained in Chapter III of the OECD Model (which is headed "Taxation of Income") represent a good indication of the items of income that are intended to fall within the scope of the treaty and are therefore indicative of the relevant nature of a tax on income for the purposes of the treaty. The scope of those individual articles is broad, encompassing profits, gains, salaries, gratuitous payments as well as gross cash flows.[47] A detailed analysis of how a DBCFT might

[45] A UK case dealing with the borderline of the distinction between turnover taxes and taxes on income is Yates v GCA International Ltd [1991] STC 157. The case involved the application of UK domestic law for relief for foreign taxation and turned on whether the Venezuelan tax charge represented an income tax or a turnover tax. It was held that Venezuelan tax charged at the rate of 90% on gross receipts was a tax corresponding to UK income tax on the basis of there being no evidence to suggest the 10% reduction was unrealistic for the majority of businesses with the result that it could therefore be an approximation to a tax on profit. It was accepted that a 10% reduction was unrealistic for the taxpayer concerned but that was considered to be beside the point.

[46] The degree to which the alternative perspectives for construing a DBCFT on this point might be pursued in any specific case would of course turn on the precise statutory expression of the tax applied to imports.

[47] OECD Model Double Tax Convention, Articles 7, 13, 15, 20 and 11.

fit within the various articles of the OECD Model is considered in the next section of this paper. For now it may be noted that, were a DBCFT to be considered to be a tax on income for the purposes of the OECD Model, this would create a number of specific problems in the application of the articles of the Model. There is therefore generally little congruence between the nature of a DBCFT and the articles of a treaty, notwithstanding their breadth.[48] The application of this line of argument therefore also presents some difficulties to the notion of a DBCFT as a tax on income.

(iv) Conclusions

The following conclusions may be drawn:

- the standards by which a tax is assessed to either constitute - or not constitute - a tax on income are vague and imprecise[49] and there is no consensus on how income should be defined[50]
- in consequence, the question as to whether a DBCFT is properly to be regarded as a tax on income does not yield a definitive answer;
- however, some of the points considered by reference to the specific features of a DBCFT do seem to represent material impediments to arguments that a DBCFT is a tax on income for the purposes of the OECD Model.

The key points are: (a) a DBCFT's similarities to the features of a VAT - especially where the DBCFT is designed to mirror a VAT with a separate reduction in the rate of labour income taxes; (b) a DBCFT's taxation of imports; and (c) the lack of congruence between a DBCFT and the provisions in Chapter III of the OECD Model.

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[48] The lack of congruence is more pronounced if the DBCFT is enacted on the R basis (rather than the R+F basis) given that in such a case financial flows would be ignored entirely, rendering Articles 10 and 11 of the OECD Model otiose.

[49] Not surprisingly, the vagueness of the notion of income causes recurrent difficulties. The difficulties are illustrated by the introduction in 1998 of the Italian tax, "IRAP" (*Imposta Regionale sulle Attività Produttive*), a broad-based, low-rate regional tax. Various features of the tax indicated the tax was closer to a turnover tax in that it was levied at each stage of production, was not based on taxable profit as normally calculated (for example, when initially introduced labour costs were not deductible at all) and is payable in the event of a loss. However, perhaps surprisingly, the IRAP has been accepted as a creditable tax (meaning it is regarded as a tax on income) under most applicable tax treaties - for example, the tax is listed in the US - Italy treaty. See Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011 at pp. 94-95. Other examples include the Estonian corporate tax following changes made in 2000 and the Argentinean levy on presumed income (MPIT) (See Marjaana Helminen, Finland: Is the Estonian Corporate Tax Covered by Article 2 and Creditable under Article 23, in Lang et al (eds.) Tax Treaty Case Law Around the Globe 2015, Linde Verlag 2016, at 25 – 32 and, in the same volume, Axel Verstraeten, Decision: National Tax Court Chamber A, Petrobas Energia Internacional SA, 14 February 2014, at 18 – 24.

[50] Helminen concludes that there is no universal definition of the notion of a tax on income in domestic law and the determination of the tax objects that are subject to income tax is a political decision - Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association 2016 at p. 162. A similar conclusion is reached in P. Essers and A. Rijkers (eds.), The Notion of Income from Capital, EATLP International Tax, IBFD Publications, The Netherlands, 2005- see the Introduction at p. xxiii.

1.2 Articles 2 (3) and (4) of the OECD Model

The discussion so far has been concerned with the notion of taxes on "income" in order to determine the scope and applicability of treaties based on the OECD Model as regards a DBCFT. However, it is also important to consider the position on the basis that the general provisions of the OECD Model set out in Article 2 (1) and (2) and which stipulate the scope of the treaty as including "taxes on income and on capital" are either entirely absent or as a practical matter given a lesser weight by one or more of the contracting states.

This is necessary because, as recognized by the OECD Model, some states do not include Article 2 (1) and (2) in their treaties and instead simply enumerate taxes covered, meaning that the version of Article 2 which they include in their treaties contains only the provisions of Article 2 (3) and (4) of the OECD Model (i.e. the enumeration of the existing taxes to which the treaty applies to, together with the "substantially similar" rule to cater for future changes).[51] Even where provisions corresponding to those in Article 2 (1) and (2) of the OECD Model are included, any enumeration of taxes in Article 2 (3) is likely to represent a complete list of relevant taxes within scope at the time of the signature of the treaty, meaning that the scope of the treaty in practice is determined by reference to the enumeration of taxes in 2 (3) and the operation of the "substantially similar" rule in 2 (4).[52]

On the basis it is a new form of tax not yet dealt with by existing double tax treaties, the matter is approached here on the basis that a DBCFT will not be an existing tax of a contracting state enumerated in Article 2 (3). The focus therefore relates to Article 2 (4) and specifically to the question whether, assuming a contracting state enacts a DBCFT, the DBCFT would fall within the scope of a relevant treaty on the basis it is, according to Article 2 (4), an "identical or substantially similar" tax that is "imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes"? A DBCFT would clearly not be "identical" to any existing tax. Would it be "substantially

[51] The approach adopted in UK treaties is mixed. For example, the UK's tax treaties with Albania, Algeria and Argentina all include provisions corresponding to the full version of Article 2, whilst the treaties with Australia, Austria and Belgium just recite the taxes covered and the "substantially similar" rule. The UK approach was generally to include only the enumeration of taxes and the "substantially similar" rule in tax treaties but this changed in the 1990s to following the full version of Article 2 of the OECD Model.

[52] Technically, however, any such listing is not definitive according to paragraph 6 of the OECD Model Commentary on Article 2. Relevant historical material suggests it is not enough to exclude income taxes by not naming them in Article 2 (3) if the provisions in Article 2 (1) and (2) are included in the treaty. Rather, they would need to be excluded expressly - OECD, WP No. 30 of the Fiscal Committee (Austria – Switzerland), Paris, 27 June 1969, FC/WP 30 (69) 1, m no.41. Even where the provisions in Article 2 (1) and (2) are excluded from a treaty, the taxes actually enumerated in the treaty should, consistent with the express purpose of comprehensive double tax treaties, be taxes on income (or on capital). The treaty restriction to taxes on income (or on capital) does not therefore disappear but the application of the "substantially similar" test will determine which taxes on income (or on capital) fall within the scope of the treaty.

similar"?[53] The answer to this question would obviously need to take account of the design options followed in the specific DBCFT concerned in any particular case.[54] However, the discussion above on the nature of a tax on "income" indicates some likely areas of difficulty as regards any argument to support a finding of substantial similarity.[55]

In practice, however, and as discussed in more detail in the next section, a state enacting a DBCFT would probably wish to ensure the tax does *not* fall within the scope of existing tax treaties. This is because, if the DBCFT were regarded as within the scope of the relevant "Taxes Covered" provisions corresponding to Article 2 of the OECD Model, the applicable provisions of the treaty concerned are likely to have the effect of materially constraining or frustrating the operation of a DBCFT. A state wishing to adopt a position that the DBCFT is not "substantially similar" to an existing corporate income tax is unlikely to find this especially challenging. In addition to the various points of difference to a corporate income tax that have already been noted, a DBCFT might be enacted under a quite separate enactment of law (such as a special DBCFT Act or Code), it might be levied at a rate of tax different to the previous rate of the corporate income tax, and to have its own separate charging and administrative and legislative machinery. The UK approach to the enactment of the Diverted Profits Tax ("DPT") in 2015 is arguably a recent example of how such an objective might be achieved. The DPT is a tax in its own right and so has its own rules for notification, assessment and payment. The DPT charge is generally imposed at 25% (which is different to the rate of UK corporation tax and the UK rate of income tax) and the charge applies to a specific measure of "taxable diverted profits" and to specific taxpayers only. There is also a special mechanism for the imposition of the charge that is different to the more usual self-assessment approach. There are therefore a number of design features that make it sufficiently different from UK corporation tax, such that it may be argued (presumably in line with the design objective) that it is not "substantially similar" to existing UK taxes for the purposes of UK tax treaties.[56] According to a

[53] According to Vogel, whether a new tax is "substantially similar" is to be determined in the context of the entire tax system, not just by comparing the new with the old tax. See Klaus Vogel, On Double Tax Conventions, 2nd edition, Kluwer, 1990, paragraph 53 at p. 97. The bounds of whether a tax is "substantially similar" to another tax are illustrated in the case of Bricom Holdings Ltd v IRC [1997] STC 1179 on which see the discussion in P. Baker, Bi-lateral tax treaty issues at 459, available at http://www.fieldtax.com/wp-content/uploads/2015/09/Bi-lateral-Tax-Treaty-Issues-and-the-OECD-Background-to-Branch-Exemption-and-the-Post-2012-CFC-Provisions.pdf.

[54] The "substantially similar" test is usually assessed by reference to the substantive attributes or characteristics of the tax concerned. In the UK case, Bricom Holdings Limited v Commissioners of Inland Revenue [1997] EWCA Civ 2193, the tax base was considered by the court to be the most important factor. See further the discussion in Marjaana Helminen, The Notion of Tax and the Elimination of Double Non- Taxation: General Report, IFA Cahier, Vol. 101B, International Fiscal Association 2016 at pp. 184-5.

[55] The scope of the "substantially similar" test, together with a number of decided cases (which are not especially instructive in this case), is discussed in Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011 at pp. 58-67.

[56] The position is also constrained by the process in the UK of enacting tax treaties into law since this is achieved by the use of individual statutory instruments which are expressed to have application only for the purposes of income tax, corporation tax and capital gains tax. This means

case on the Denmark-France DTA of 1957, the position is not altered by the fact that a new tax is intended to replace an existing one. In that case, it was held by the Danish Administrative Court that it is not sufficient for the "substantially similar" test to be met that a duty is imposed in lieu of a tax listed in the treaty enumeration of taxes covered.[57] The test therefore requires

1.3 Position under the US – UK treaty

As noted, the ongoing tax reform discussions in the US include as one option the introduction of a DBCFT, making the issue discussed here of potential relevance in the context of existing treaties, such as the US-UK treaty of 2001. Article 2 of the US-UK treaty essentially follows Article 2 of the OECD Model, with provisions corresponding to all four paragraphs of Article 2 of the OECD Model.[58]

The US taxes enumerated in Article 2 (3) of the US-UK treaty are the US federal income taxes imposed by the U.S. Internal Revenue Code and federal excise taxes on insurance policies issued by foreign insurers and with respect to private foundations.[59] This means that, if a DBCFT were introduced by the US, it might be expected that the question of whether that tax fell within the treaty would be determined by whether it would be regarded as a tax on income and by the "substantially similar" test of Article 2 (4) of the treaty. However, Article 1 (3) (a) (i) of the treaty provides that any question of whether a "tax measure" is within the scope of the treaty is to be determined exclusively in accordance with the Article 26 mutual agreement procedure.[60] The treaty contains a broad definition of "tax measure" for these purposes, which includes "a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action" (Article 1 (3) (b)). Under the mutual agreement procedure the relevant competent authorities of the US and UK would consult each other and "endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application" of the treaty (Article 26 (3)). The same provision

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that the provisions of the treaty cannot be given effect for the purposes of UK law in relation to other taxes such as the DPT. In principle, however, the status of the DPT is, however, not clear-cut given that the tax base as regards the amount of profits that are regarded as "diverted" is arguably similar to that of the UK corporation tax .

[57] Danish Administrative Tax Court (*Landsskatteretten*) Case No. 1985-5-173, decision of 22 May 1985; discussed in Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011 at p.65..

[58] The approach adopted in the US-UK treaty also follows both the 2006 and 2016 versions of the US Model Income Tax Convention, though a number of other US treaties exclude provisions corresponding to Article 2 (1) and (2) of the OECD Model, with their respective Article 2 provisions limited to the enumeration of the specific taxes covered – as in, for example, the US treaties with Australia, China, Sweden and Venezuela.

[59] There is no reference made to capital taxes. The UK taxes enumerated are income tax, capital gains tax, corporation tax, and petroleum revenue tax.

[60] This provision forms part of the US Model Income Tax Convention – see Article 1 (3) a) i) and b) of the US Model Income Tax Convention of 17 February 2016. The measure was also included in Article 1 (3) of the earlier versions of the U.S. Model dated November 15, 2006 and September 20, 1996. The measure is included in a number of US treaties such as the those with Sweden (1996), Venezuela (2000), Bulgaria (2007) and Malta (2008) though absent from earlier US treaties, such as those with Australia (1982) and China (1984).

also allows the competent authorities to consult each other in cases of double taxation not provided for in the treaty (Article 26 (3)).[61] This means that, for the purposes of the US-UK treaty, the status of a DBCFT would be determined by this mutual agreement process between competent authorities.[62]

1.4 Conclusion: Is the DBCFT is Within the Scope of Double Tax Treaties?

In testing whether a DBCFT is within the scope of comprehensive double tax treaties by reference to the OECD Model, the primary question is whether the DBCFT amounts to a tax on "income" for the purposes of Article 2 of that Model. Given the absence of precise tests for determining that issue, it is not surprising that no definitive answer is available. However, there are features of the DBCFT that do not seem readily accommodated in the notion of a tax on "income" that has previously been adopted. Further, if the relevant articles in tax treaties are taken as a guide to what is intended in relation to the intended scope of treaties, the DBCFT is a poor fit given that a number of treaty provisions that are either irrelevant or in conflict with the DBCFT (this point is explored in more detail below).

As a practical matter, the scope of tax treaties as regards taxes covered is left to the states entering into the treaty concerned in any particular case – as reflected in any particular treaty by the enumeration of the taxes covered. It seems likely that states enacting a DBCFT will have a clear goal in determining how the provisions of existing treaties should interact with a DBCFT. For reasons explained in more detail in the next part of this paper, we expect that any such state would wish to exclude any DBCFT from the scope of an existing treaty in order to avoid the treaty frustrating its intended operation. If so, this means that states enacting a DBCFT are likely to reflect this goal in their choice of design options in implementing the DBCFT – drawing on, for example, the lessons of the UK DPT to ensure the DBCFT cannot be regarded as "substantially similar" to any previously existing corporate income tax (for the purposes of Article 2 (4) of the OECD Model)..

In the case of the specific situation under the US-UK DTA, any new tax, such as the DBCFT, is to be dealt with by the mutual agreement procedure between the competent authorities. This would lead to a negotiation process between the signatory states, in all likelihood featuring technical, policy and political factors.

[61] In the US-UK treaty the rule of interpretation of Art 3 (2) is also modified to allow recourse to mutually agreed terms arrived at under the mutual agreement procedure.

[62] Under Article 2 (4) of the treaty there is an obligation on the competent authorities to notify each other of changes made in their respective taxation or other laws that significantly affect their obligations under the treaty.

2. What are the implications of the DBCFT being within or alternatively outside the scope of the taxes covered by double tax treaties?

The consequences of a DBCFT being within, or alternatively outside, the scope of treaty provisions dealing with the taxes covered by the treaty (corresponding to Article 2 of the OECD Model) has a fundamental impact on the operation and relevance of the treaty in any specific case. It seems somewhat odd that so fundamental a point is not made expressly in the OECD Model, but Article 2 is wholly and mutually interdependent with the distributive provisions in Articles 6-22. In consequence, any limitation on taxing rights in the distributive articles of the treaty (e.g. in Article 7 on business profits, Article 11 on interest and Article 13 on capital gains) relates *only* to the "taxes covered" within Article 2.[63] The position is different for specific treaty articles dealing with non-discrimination, exchange of information and mutual assistance (Articles 24, 26, 27 in the OECD Model) as these provisions have a wider scope reflecting a different policy purpose.

The analysis below addresses first the position if the DBCFT were - in line with what seem to be the implications of the above analysis - not regarded as a tax on income, preventing it from falling within the ambit of the "Taxes Covered" in Article 2 of the OECD Model. Consideration is then given to the alternative position, under which the DBCFT would be regarded as falling within the scope of Article 2. The discussion is largely focused on the position under an existing treaty (using the OECD Model as a guide) where one of the contracting states to the treaty has, or is enacting, a DBCFT (the DBCFT state) and other contracting state does not but operates a traditional corporate income tax system (the non-DBCFT state).[64]

2.1 Implications where a DBCFT is outside the scope of the taxes covered by double tax treaties

If the DBCFT falls outside the scope of the "taxes covered" under Article 2, the position would be broadly analogous to the situation in which one of the contracting states operates a VAT in its tax system. The more detailed implications are discussed below.

Treaty provisions rendered irrelevant or inapt

As a result of not being within the scope of Article 2, the DBCFT would not be covered by the distributive articles of the OECD Model (Articles 6-22) though that would have no effect in relation to Articles 15-20 as those articles are not

[63] Though not common, it nonetheless remains possible to modify the scope of individual articles of the treaty to take account of taxes specifically referred to in those individual articles – see further Austrian Supreme Administrative Court, case No. 2000/13/0134 regarding Article 8 of the Austria–Japan Income Tax Treaty of 1961, decision of 28 March 2001.

[64] The discussion here is not intended to address the position as between Member States of the European Union and therefore issues relating to compliance with the European Treaties are beyond the scope of this discussion.

concerned with the taxation of business profits. The Article 25 Mutual Agreement Procedure ("MAP") would also not be available in relation to the DBCFT. Notwithstanding that the DBCFT would fall outside the scope of the treaty, the existing treaty limitations on the taxing rights of the non-DBCFT other contracting state would remain applicable. This asymmetric operation of treaty provisions is likely to raise a number of policy issues and concerns for the non-DBCFT state which are discussed below.

The provisions of Article 23, which is concerned with the relief of double taxation, would in this situation also be irrelevant in relation to the DBCFT. This means that, in the DBCFT state, any treaty obligations to apply exemption or credit mechanisms to avoid double taxation in relation to income taxed in the non-DBCFT state would not be applicable (because the DBCFT tax charge, being other than a tax on "income", would not be regarded as giving rise to double taxation of the sort targeted by Article 23). In the non-DBCFT state, those treaty obligations would similarly be inapplicable with respect to the DBCFT as again the DBCFT would not be regarded as a tax that gives rise to double taxation of the sort targeted by Article 23. This raises some fundamental questions on the status of established efforts to prevent double taxation, which are discussed further below.

Provisions of the Treaty that would remain operative in relation to a DBCFT

Notwithstanding a finding that the DBCFT falls outside the scope of Article 2, three articles of any treaty based on the OECD Model would continue to operate in relation to the DBCFT. These are: Article 24 (Non-Discrimination), Article 26 (Exchange of Information) and Article 27 (Assistance in the Collection of Taxes).

Article 24 of the OECD Model contains specific non-discrimination rules and, importantly in the present context, applies to "taxes of every kind and description" of the contracting states, meaning that a DBCFT is subject to the provisions of the Article even if it is regarded as falling outside the scope of Article 2.[65] Although Article 24 establishes the non-discrimination principle in tax treaties, the scope of Article 24 is defined by five specific rules barring discrimination by a contracting state in particular circumstances (being certain

[65] Article 24 (6) of the OECD Model. The relevant historical material implies that the provision is intended to encompass the widest possible spectrum of taxes. See the 1958 draft version of the OEEC Fiscal Committee (Netherlands France) Final Report on Tax Discrimination on Grounds of Nationality or Similar Grounds, FC/WP 4(58) 1, Paris 19 February 1958 as discussed in Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011 at pp. 134-140. Some states, however, seek to limit the provision to taxes actually covered by the treaty. This was generally the position of the UK – see P. Baker, Double Tax Conventions, Sweet & Maxwell at 2B.10, footnote 2. The UK position is however not universally adopted – the non- discrimination article in the treaty US-UK treaty (Article 25) adopts the OECD Model wording "taxes of every kind and description" and applies on a broad footing to taxes imposed by the contracting states. However, as noted earlier, the UK position is in any event constrained by the statutory instrument process of enacting tax treaties into law, which means that the treaties cannot be given effect in relation to taxes other than income tax, corporation tax and capital gains tax.

specified transactions or events,).[66] It is necessary to assess the status of the DBCFT under these non-discrimination rules.

Article 24 (1) provides that "nationals" (which includes legal persons such as companies) of one contracting state may not to be subject to any taxation or connected requirement in the other state, in particular with respect to residence, which is more burdensome than the taxation and connected requirements to which nationals of the other state in the same circumstances are or may be subject. Given that a DBCFT would apply equally to all taxpayers and makes no distinctions based on status as a "national", residence, etc. this provision should not be relevant. Article 24 (2) contains a similar rule but by reference to "stateless persons" rather than nationals. It should be inapplicable to a DBCFT for the same reason as Article 24 (1). The rule in Article 24 (3) requires equal treatment of permanent establishments and local enterprises "carrying on the same activities". Since a DBCFT treats all taxpayers (including resident companies and permanent establishments of non-resident companies) by reference to the same set of rules and make no distinctions based on whether or not the taxpayer is a permanent establishment, the rule should also not be in point. Article 24 (5) broadly requires equality of treatment of enterprises irrespective of whether their capital is owned by residents of the other contracting state. Again, a DBCFT should not raise difficulties under this provision.

This leaves Article 24 (4), which might be considered potentially more relevant to a DBCFT. Article 24 (4) requires that:

- save in some exceptional circumstances (that are not relevant here)
- certain designated payments (specifically "interest, royalties, and other disbursements")
- paid by an enterprise of one contracting state to a resident of the other
- shall for the purposes of determining the taxable profits of such enterprise
- be "deductible under the same conditions" as if paid to a resident of the first state.

The features that warrant immediate consideration in this context relate to the border adjustments that are made under a DBCFT, namely the treatment of exports and imports. The general tax exemption under a DBCFT for exports (and the possible general exemption, depending on the precise form of the DBCFT, for financial flows) is not concerned with deductibility and therefore does not trigger a non-discrimination issue under Article 24 (4). With regard to imports, and to re-state the basic approach under the DBCFT, imports (including overseas staff costs) are, depending on the DBCFT model adopted, either (1) totally ignored - i.e. not deductible and not taxable or (2) a deductible cost for the importer yet also taxable. The effect of (1) and (2) is the same, being no

[66] Kees van Raad has described the provision as "an incoherent collection of fairly narrow clauses" – see Kees van Raad, Issues in the Application of Tax Treaty Non Discrimination Clauses, 42 BIFD 347 (1988).

deduction *in economic effect* for imports. The general approach of the DBCFT can be applied to the categories of payment mentioned in Article 24 (4) as follows:

- Interest – not deductible at all under the "R" base but deductible under the "R+F" base.[67]
- Royalties – under both R and R+F bases, deductible in the case of payments to in-country recipients but in the case of payments cross-border either ignored altogether or both deductible and taxable as an import.
- Other disbursements - under both R and R+F bases, deductible in the case of payments to in-country recipients but in the case of payments cross-border either ignored altogether or both deductible and taxable as an import.

It might be argued there is a clash between a DBCFT and the provisions of Article 24 (4) on the basis that the DBCFT gives no deduction for payments cross-border of: interest (under the R+F base); royalties; and other disbursements - yet Article 24 (4) requires that such payments, when made to a resident of the other contracting state should be "deductible under the same conditions" as if paid to a local resident. However, any such argument is not convincing as it conflates payments "to a resident of the other contracting state" (Article 24 (4)) with cross-border payments in respect of imports. A DBCFT makes no such distinction of the sort contemplated by Article 24, namely by reference to residence status.[68] For example, payments are deductible in a state adopting a DBCFT if they are made to a local (i.e. same country) recipient, whether to a locally resident company or to a local business operation (i.e. a permanent establishment) of a non-resident. Equally, no deduction is available under a DBCFT where a payment is made by a local resident, or a permanent establishment of a non-resident company, where that payment is made to a recipient in the other state (representing an import) irrespective of whether that payment is made to an enterprise resident in the other state or to a permanent establishment of an enterprise which is resident in the DBCFT state. Therefore, because residence status is irrelevant under a DBCFT to the question of deductibility, the provisions of Article 24 (4) should not be in point. Put another way, the designated payments in Article 24 (4) are, under a DBCFT, "admissible under the same conditions as if they had been paid to a person resident in the taxing state". This accords with Article 24 because that article is intended to target specific forms of discrimination by reference to particular criteria[69] - in particular, residence - rather than to counter on a more general basis distinctions made in the tax system.

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[67] It is beyond the scope of this paper to include any detailed discussion of the R+F base, though further explanation is available from the article referred to in footnote 3, Destination-Based Cash Flow Taxation, which is available at: http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf

[68] It is significant that the non-discrimination provisions in Article 24 "apply to the taxation of the person and not the income" – John F Avery Jones et al, The Non-Discrimination Article in Tax Treaties, British Tax Review, 1991 No. 10, at p. 359.

[69] The first sentence of the OECD Model Commentary to the Article reads: "This Article deals with the elimination of tax discrimination *in certain precise circumstances*" [emphasis added].

A second (though probably less strong) line of argument might also be available in the situation where the treatment of imports under a DBCFT involves a deduction for the importer with a separate tax charge on the import (rather than the alternative of ignoring imports altogether). In this situation, it might be argued a deduction *is* in any event available so that the rule in Article 24 (4) is not triggered. Given the tax charge on the import, such an argument may be vulnerable to the objection that the deduction is not available "under the same conditions" as when paid to a resident of the state concerned, as required by Article 24 (4). However, the requirement of Article 24 (4) is narrowly framed by reference to *deductibility* in comparison with, for example, the broader wording used in Article 24 (1) and (2) (where the provision targets the broader "taxation or any requirement connected therewith"). Further, the taxation of the import under the DBCFT is in economic terms a tax charge *on the exporter*[70] rather than on the importer, and might be framed as such in any tax statute enacting a DBCFT.[71] This suggests that the determination of the point could be influenced by the specific design choices made in the enactment of a DBCFT in any particular case.

The articles on exchange of information and mutual assistance in tax collection (Articles 26 and 27 respectively) are also not restricted by the scope of Article 2 and so would continue to apply.[72] This means Article 26, Exchange of Information, would provide for an exchange between the contracting states for purposes that would include such information as is foreseeably relevant for "the administration or enforcement of the domestic laws concerning taxes of every kind and description". This would clearly include a DBCFT. There is a similarly broad scope to Article 27, Assistance in the Collection of Taxes, which provides that the contracting states are to lend assistance to each other in the collection of "revenue claims", which, in Article 27 (2) is also defined to mean amounts owed in respect of taxes of every kind and description.[73]

The approach to exchange of information and mutual assistance is dealt with differently in the US-UK treaty. The two separate Articles of the OECD Model are combined in a single Article in the US-UK treaty – Article 27 – and the scope of the exchange of information provisions in that article is limited to the taxes covered by that treaty (Article 27 (1)) while the approach of the OECD Model to

[70] The tax charge matches the tax charge a producer of the goods in the state of the sale would have paid, though there is no exact equivalence as the labour costs of the exporter would not be deductible but the costs of a producer in the state of sale would be deductible.

[71] The treaty would not stand in the way of such taxation if the DBCFT is not a covered tax within Article 2, though presumably it would in turn lead to a question whether such taxation of the exporter triggered a non-discrimination issue under Article 24 (1) – the arguments on that point would be similar to those considered here. Where the tax charge is framed as applying to the exporter, the tax system would presumably need to deal with measures to collect the tax.

[72] Article 26 (1) and Article 27 (1) and (2) expressly provide that the relevant exchange of information and mutual assistance is not to be restricted by Articles 1 and 2 as long as not relating to a tax which is "contrary to the treaty". The DBCFT is not "contrary to the treaty" as such, merely (as assumed here) outside the scope of Article 2.

[73] It is specifically contemplated in paragraph 18 of the OECD Model Commentary that a request under Article 27 may relate to a tax that does not exist in the requested state.

mutual assistance is appreciably narrowed, with the relevant provisions in the US-UK treaty consisting of assistance to ensure that relief granted by the treaty does not arise to persons who are not entitled to the benefit of the treaty (Article 27 (5)).

Other (non-business tax) provisions of a DTA

Treaty articles not dealing with business income would continue to operate as normal. This includes Article 15 (income from employment), Article 16 (Directors' Fees), Article 17 (Entertainers and Sportspersons), Article 18 (Pensions), Article 19 (Government Service), and Article 20 (Students).[74]

Conclusion where a DBCFT is outside the scope of the taxes covered by double tax treaties

Where a DBCFT is outside the scope of the taxes covered by double tax treaties the bulk of the treaty articles otherwise applying to the taxation of business would be simply inapplicable and would therefore have no effect in the case of the DBCFT. Critically, this includes mechanisms for addressing double taxation. The articles dealing with the exchange of information and mutual assistance provisions would remain applicable in the case of a DBCFT and may be helpful to its operation. The non-discrimination article would also remain applicable but for the reasons set out above should not be relevant to the operation of the DBCFT. The articles in the treaty dealing with matters other than business tax would be unaffected by the DBCFT.

2.2 Implications where a DBCFT is within the scope of the taxes covered by double tax treaties

Where it is concluded that the DBCFT is a tax on income and therefore a covered tax for the purposes of Article 2, the treaty provisions would be applicable in relation to the DBCFT. This leads to a number of difficulties that potentially frustrate the operation of the tax.

The discussion in the previous section (where the DBCFT is assumed to be outside the scope of Article 2) includes some consideration of the treaty provisions that could either remain operative in relation to a DBCFT (i.e. relating to exchange of information, mutual assistance and non-discrimination) or which would not be affected by any DBCFT (i.e. those articles that are not concerned with the taxation of business income). In both case, the analysis does not change where the DBCFT is assumed to be within the scope of the taxes covered by Article 2, and so is not revisited here. The discussion in this section therefore

[74] The corresponding articles in the US-UK treaty are Articles 14 (income from employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen), 18 (Pension Schemes), 19 (Government Service), 20 (Students). There are in addition two articles not included in the OECD Model, namely Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) and Article 20A (Teachers).

focuses on the impact of the treaty's distributive articles in the situation where the DBCFT *is* regarded as a tax on income.

Treaty Provisions impacting on a DBCFT

The relevant distributive articles that need considering because of the possible relevance to the operation of a DBCFT are Articles 6-13, and 21-22. Article 23 (methods for elimination of double taxation) and Article 25 (mutual agreement procedure) would also operate in a different manner than in the case where a DBCFT is regarded as falling outside the scope of Article 2 and so also require consideration.

The primary issue arising from the analysis of the distributive articles is that the operation of some (but not all) of these articles would constrain or frustrate the DBCFT. This is because the relevant articles of the OECD Model impose limitations on taxation rights that are incompatible with the intended operation of that tax, namely, the in-country sales that are seen as its proper domestic tax base. The following discussion deals first with those articles where there would be (or may be) an impingement upon the operation of the DBCFT.

Article 7 - There would be an obvious problem with the DBCFT state taxing the local sales of an overseas company resident in the non DBCFT state where the latter company did not have a permanent establishment in the DBCFT state. Also, whether there is a permanent establishment or not, the DBCFT charge is very unlikely to conform to the measure of tax on "the profits that are attributable to the permanent establishment" as required by Article 7.

Article 8 - This article provides that profits from the operation of ships or aircraft in international traffic, and profits from the operation of boats engaged in inland waterways transport, are taxable only in the contracting state in which the place of effective management of the enterprise is situated. If that state is the non-DBCFT state but sales are made in the DBCFT state, then any DBCFT charge would run counter to the provisions of the article.

Article 12 provides that royalties arising in one contracting state and beneficially owned by a resident of the other contracting state are taxable only in the other state. The DBCFT would not be contrary to this article where a cross border royalty payment were made from an entity in the non-DBCFT state since that would be consistent with the existence of a (non-taxable) export from the DBCFT state of whatever it is that the royalty is paid in respect of, which is how it would be treated under the DBCFT. However, where the payment is made by an entity in a DBCFT state the position is less straightforward. This is because the situation would, under the DBCFT, be construed as an import of whatever it is that the royalty is paid in respect of. The consequences for the purposes of the treaty provision in Article 12 turn on whether the taxation of the import under a DBCFT may be regarded as quite separate to the treatment of the royalty payment itself such that it does not constitute a tax on or in relation to the

royalty payment. Therefore, it may well be argued that a DBCFT charge on the import breaches the provisions of Article 12 in the case where a royalty is paid.[75]

Article 13 – This article on capital gains permits taxation in the "source" state in the case of immovable (i.e. real) property referred to in Article 6, movable property forming part of the property of a permanent establishment, and also gains from the alienation of shares deriving more than 50% of their value from immovable property in the source state (Article 13 (1), (2) and (4) of the OECD Model). These are "permissive" provisions that do not run counter to the operation of a DBCFT (which would ignore them). However, Article 13 also provides two limitation rules: namely that gains from the alienation of ships or aircraft operated in international traffic and boats engaged in inland waterways transport are to be taxable only in the state where the effective management of the enterprise is situated (Article 13 (3)) and that gains from the alienation of any property other than that referred to in the above-mentioned rules are to be taxable only in the state of which the alienator is resident (Article 13 (5)). In either case, these two limitation rules may conflict with a DBCFT, for example in a case where a gain of an entity resident in the non-DBCFT state is achieved by a sale made in the DBCFT state.

Article 21 ("Other Income") requires that items of income of a resident of a contracting state, wherever arising, which have not expressly been dealt with in the various articles of the Model are to be taxed only in the state of the resident. As with the other articles considered above, this rule on the limitation of taxing rights could readily conflict with the operation of a DBCFT – for example, where income falling within the article arises as a result of a sale transaction made by a resident of the non-DBCFT state in the DBCFT state.

The remaining distributive articles are generally inapt given the nature of the DBCFT but they do not positively frustrate its operation.

Article 6 allows residents of one state to be taxed on income from immovable property situated in the other state to be taxed in that other state. The provision is therefore merely permissive in nature so if the taxing right relating to such income is not taken up in the DBCFT state (as it would not be) the article would have no effect in the DBCFT state.

Article 9 – this article deals with transfer pricing adjustments and caters also for corresponding adjustments in the event of a mispriced transaction between two affiliates – one located in the DBCFT state and the other in the non-DBCFT state. The rule is theoretically in point. However, in practice the transfer pricing rule has no application in the DBCFT state as transfer pricing adjustments are, for different reasons in the case of exports and imports, not needed under a DBCFT. In the case of exports, there is no domestic tax under a DBCFT so the seller has no incentive to manipulate or adjust (under the corresponding adjustment provisions of Article 9 (2)) the transfer price. As regards imports, a purchaser in

[75] The issue raises similar issues to those considered earlier in relation to Article 24 on non-discrimination and relating to the degree to which the payment for an import can be considered as separate from the taxation of the import under the DBCFT.

the DBCFT state is specifically taxed on any import but, as it represents an input into the business of the purchaser, a deduction for the cost of the goods purchased is also permitted, with the result that the two effects should net out to zero, leaving any domestic sales subject to the tax. The overall result is that manipulation of transfer prices generally achieves no tax benefit in the state of the seller or buyer under the DBCFT.[76] As a general matter, Article 9 does not fit particularly well with the operation of a DBCFT.

With regard to Article 10 (dividends), a DBCFT would not tax dividends and since the article is permissive in nature it should not interfere with the operation of the DBCFT.

Article 11 (interest) is also permissive but Article 11 (2) includes a limitation on taxation in the state in which the interest arises. A DBCFT would ignore interest altogether (under a R base) or tax the recipient of interest (under a R+F base) but it would not impose a withholding tax of the sort contemplated by Article 11 (2). Accordingly, though Article 11 imposes a limitation on the "source" state taxing rights, this would be irrelevant if that source state operated a DBCFT.

Article 22 – this article dealing with the taxation of capital is similar to Article 13 (which deals with capital gains) in that it enumerates (in Article 22 (1)-(3)) some limited situations in which taxation in the source state is permitted (i.e. capital represented by: immovable property referred to in Article 6; movable property forming part of the business property of a permanent establishment; and ships and aircraft operated in international traffic and boats engaged in inland waterways transport) before then providing (in Article 22 (4)) a limitation rule, namely that all other elements of capital of a resident of a contracting state shall be taxable only in that state. Though this latter rule introduces a limitation on the right to taxation, the DBCFT is not a tax on capital as such.[77] For this reason the provisions of the Article appear not to be in conflict with the DBCFT.[78]

Although not distributive articles that deal with the limitation of taxing rights per se, two other articles – 23 and 25 - of the OECD Model should also be considered here.

[76] The position under the DBCFT is in contrast to the position under the existing international system where there is an incentive to manipulate transfer prices because of the difference in country tax rates and the fact that the price of goods or services sold from one jurisdiction to another will be subject to tax in the seller's jurisdiction and will be a deductible cost in the purchaser's state. However, there may be some specific situations in which the transfer price does have a tax impact in a DBCFT state, depending on the design features of that tax system – for example, a loss-making importer may have an incentive to minimize the price of goods imported from an affiliate in order to reduce the up-front taxation of the import, given that tax relief for the cost of the import might be achieved only at a later date.

[77] There is a somewhat circular definition of the capital taxes contemplated by the OECD Model in Article 2 (3) of the OECD Model. This includes taxes on total capital, or on elements of capital or taxes on capital appreciation.

[78] There is no article corresponding to Article 22 of the OECD Model in the US-UK treaty given that capital taxes are not included in the scope of that treaty.

Articles 23 A and B provide for the elimination of double taxation by the exemption method (Article 23A) or the credit method (Article 23B). As a practical matter, the provisions would not work at all well due to the entirely different base of the DBCFT as against a traditional corporate income tax. For example, if a company in the DBCFT state had a permanent establishment in the non-DBCFT state, it is provided that either the relevant income (i.e. profits) of that permanent establishment would fall to be treated as exempt, or the relevant tax levied on that permanent establishment would be creditable, in the DBCFT state. If the activities of that permanent establishment had generated sales *in the DBCFT state* this would frustrate the intended operation of the DBCFT. Further, the calculation of any exemption of income or credit for tax would be based on the income or profit "attributable" to the permanent establishment under Article 7 of the OECD Model, a measure that would be wholly meaningless under the DBCFT. Similar difficulties would arise in the converse situation.[79]

Article 25 provides for the mutual agreement procedure between the competent authorities of the contracting states. On the assumption that the DBCFT is a covered tax for the purposes of the treaty, any clash between the operation of the DBCFT and the provisions in the treaty (as in the various cases discussed above) would potentially fall within Article 25, meaning an aggrieved taxpayer could pursue any matter relating to taxation "not in accordance with the provisions" of the treaty through the competent authority process. The OECD Model provides that any issues that remain unresolved after two years of the issue being raised may be submitted to arbitration, though this provision is often varied in DTAs. The corresponding provisions in the US-UK treaty are in Article 26 of that treaty and also include a number of possible matters which the competent authorities are free to agree on (such as the same income attribution or the same allocation of deductions) though these seem unsuitable as mechanisms to reconcile the competing tax claims of a DBCFT and a traditional corporate income tax.

Conclusions where a DBCFT is within the scope of taxes covered by double tax treaties

The discussion above highlights some obvious problems and issues which would arise under the distributive provisions in the situation where a DBCFT was regarded as falling within the scope of the taxes covered by Article 2. As noted, these issues are very likely to impede the intended operation of the DBCFT by reference to what is considered its proper domestic base of in-country sales. Though technically applicable, the provisions on the elimination of double taxation would not work particularly well given the entirely different bases of the DBCFT as against a traditional corporate income tax. In some situations those provisions would also interfere with the intended functioning of a DBCFT.

[79] The corresponding provisions in the US-UK treaty are contained in Article 24 and adopt the credit method for relief from double taxation. The Article specifically identifies creditable income taxes as those taxes falling within paragraphs (3) and (4) of Article 2.

3 What are the Key Policy Considerations?

The discussion so far raises a number of technical matters but it is also likely also to mean that individual states would have relevant policy objectives and policy concerns. These may be considered by reference to the likely policy considerations for DBCFT states on the one hand and non-DBCFT states on the other. It is also relevant to consider some wider questions, such as concerns relating to double taxation.

Policy Considerations for States with a DBCFT

The discussion above suggests that, if a DBCFT is within the scope of taxes covered by a treaty, it is likely to interfere in various ways with the intended operation of the DBCFT. This means that DBCFT states would probably wish, if possible, to exclude DBCFT from the scope of its existing treaties, an objective that might best be delivered by enacting a DBCFT in a new and separate statute and by adopting the tax in a form which is close to a VAT. As regards the provisions in a treaty which are not concerned with business income, a DBCFT state would presumably wish to keep its existing double tax treaties in place in order to deal with the interaction of its tax system with those of treaty partners.

Policy Considerations for States with Traditional Corporate Income Tax Systems

A non-DBCFT state might regard the DBCFT generally as unwelcome given the treatment of imports and exports under that tax. This would be on the basis that the treatment of exports and imports under a DBCFT penalizes the provision of goods and services in both countries by businesses in the non-DBCFT relative to those in the DBCFT state. However, such a view may be challenged on the basis that any such effect is at most a temporary one.[80]

A non-DBCFT state may also have other treaty-based concerns in relation to the expected policy position of a DBCFT state (as described above). There are two main reasons for this. First, the expected policy position of the DBCFT state would lead to any existing treaty being applied asymmetrically as regards the contracting states' respective tax systems for taxing business profits, bringing about a significant shift in the balance of the treaty deal originally struck

[80] In the short run, the introduction of the DBCFT would generate a stimulus to domestic production relative to foreign production. Over the longer run, however, prices would adjust. Expansion of domestic production would lead to an increase in the demand for labour. This would in turn push up the wage rate, and in consequence, push up the price of domestically produced goods and services. The effect of this rise in prices and wages would be to begin to raise again the price of exports on the world market, and to raise the price of domestically-produced goods relative to imports. When domestic prices and wages had risen far enough, the initial real equilibrium would be re-established. In the long run therefore, there would be no overall impact on trade, due to the price adjustments. The analysis is dealt with in more detail in Alan Auerbach, Michael Devereux, Michael Keen and John Vella, Destination-Based Cash Flow Taxation, Oxford University Centre for Business Taxation, Working Paper 17/01, available at http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701c.pdf at pp. 17-20.

between the contracting states.[81] Second, the consequences would potentially create opportunities for tax planning in relation to tax charged in the non-DBCFT state.

Where it is concluded that the DBCFT is outside the scope of the taxes covered by a treaty, the asymmetric operation of that treaty would stem from a number of the specific articles in the treaty operating to limit or remove the taxing rights of the non-DBCFT state in relation to its domestic tax system and in favour of the DBCFT state, without any corresponding limitation of the taxing rights of the DBCFT state (as the DBCFT would not be a tax covered by the treaty). Further, given that the DBCFT state would presumably wish to ignore those taxing rights and instead tax business profits according to the intended properties of a DBCFT, this could potentially lead to what might be seen as "double non-taxed" income and create opportunities for tax planning.[82] For example, in the DBCFT state the treaty rules in Article 7 on the attribution of profits to permanent establishments would be largely irrelevant as regards any permanent establishment in the DBCFT state of an entity resident in a non-DBCFT state. Where the non-DBCFT state operates an exemption system, a resident of the non-DBCFT state may exploit this situation by structuring its activities so that the activities relating to sales outside the DBCFT state (and including sales in the non-DBCFT state concerned) are located in a permanent establishment in the DBCFT state, with the result those activities would be taxed nowhere – not in the DBCFT state because they would not relate to sales in that state and not in the non-DBCFT state because the relevant activity would be located in the DBCFT state. Similar arrangements might be made to ensure payments within Article 21 (Other income) or within Article 11 (Interest) were made from entities in the non-DBCFT state to entities resident in the DBCFT state, with the result they might be tax-deductible and non-taxable respectively.[83] The provisions of Article 8 could also be exploited by arranging for the effective management of an enterprise carrying on shipping, air transport, etc. activity in the non-DBCFT state to be located in the DBCFT state. As in the above examples, this would have no effect in the DBCFT state (which would apply the DBCFT to tax only in-country sales) but would prevent taxation in the non-DBCFT state.

This situation may lead to a variety of possible responses by the non-DBCFT state by reference to the polarities of outright resistance on the one hand and also adopting the DBCFT on the other. An approach of resistance to the DBCFT

[81] However, the concern of a non-DBCFT state would arguably be less with the introduction of a DBCFT itself (particularly where it is accepted that it is in broad terms similar to a VAT) but rather with the removal in the DBCFT state of any corporate income tax.

[82] The concern on the part of states with situations of "double non-taxation" has been amplified in recent years, particularly since the BEPS project, and has led to a variety of counter measures – as reflected , for example, in the counter measures inserted into in the new US Model Tax Treaty to counter payments to low tax zones and to states with privileged tax regimes. See at https://www.treasury.gov/press-center/press-releases/Pages/jl0356.aspx

[83] In a DBCFT state, the provisions of Article 4 of the OECD Model on residence are likely to be largely or wholly irrelevant as regards corporate residence and it is possible that a corporate residence test may be excised from the law. If not, the position might be exploited by the creation of corporate residence in DBCFT state with a view to diverting various types of treaty-protected income to that state from a non-DBCFT state.

may be reflected in a wish on the part of the non-DBCFT state to renegotiate the treaty allocation of taxing rights as well as in more penal responses such as potentially seeking the ability to over-ride any treaty and impose withholding taxes on, or deny the deductibility of flows of income to, the DBCFT state, or to apply CFC rules where possible. A drawback to this potential response by the non-DBCFT state, however, is that such actions would be likely to reinforce the advantage to business of locating in the DBCFT state. Even in the absence of such responses, businesses may seek to locate in the DBCFT state to take advantage of the lack of a source-based conventional tax on capital income there. The more that the non-DBCFT state imposes tax on its own resident businesses, the greater the incentive for businesses to relocate to the DBCFT state. This suggests that the long term response of the non-DBCFT state might instead be to adopt the DBCFT itself.

Wider Policy Issues

The discussion above on the likely policy issues for a DBCFT state assumes the priority of that state would be in enacting and operating the DBCFT by reference to the intended nexus of that tax relating to domestic sales. The chief drawback of that approach is that, if a DBCFT is not a covered tax for the purposes of double tax treaties, there will be no ability to deal with double taxation. Given the entirely different bases of the DBCFT and traditional income tax, cases of such double taxation could be extensive (for example, goods produced or services rendered by an enterprise in a non-DBCFT state which are sold in the market of the DBCFT state would be taxable by both states under their different tax systems). However, it is notable that little concern about double taxation tends to be voiced where an enterprise is subject to a corporate income tax in one state and a VAT in another state (as might be the case currently where, for example, a US company manufactures its products in the US and sells them in the UK market). This suggests that if the DBCFT were regarded as being equivalent to a VAT concerns about double taxation may in practice be somewhat muted.

The discussion here brings out the marked unsuitability of double tax treaties to deal with any conflicting tax claims of the DBCFT on the one hand and traditional corporate income tax systems on the other. In the light of the matters discussed earlier relating to the effective incidence of a VAT, it also raises questions about the limited nature of the *juridical* double tax that represents the declared focus of the efforts of the OECD Model.[84]

It might be argued that this situation confirms why it is important to stick with the current international tax system. However, in policy terms at least, that would seem an ossifying or perhaps even ironic position, given that the primary

[84] The focus of the OECD Model on juridical double tax is confirmed in the Introduction to the OECD Model, at paragraph 3 and in the Model Commentary on Article 23. The nature of juridical double taxation is that it involves the same income or capital being taxed in the hands of the same taxpayer by more than one state. Economic double taxation, from which it may be distinguished (and which is not the focus of the OECD Model's attempts to eliminate double taxation), involves two different taxpayers being taxed in respect of the same income. See further OECD Model, Commentary to Article 23A and 23B, paragraphs 1-3.

driver for the creation of the DBCFT is the objective of creating a better international tax system.[85] In the development of the international tax system, a very early - and deliberate - decision was taken as far back as 1925 to restrict the focus of efforts on double taxation to those taxes levied, broadly, on income, even though it was recognized double taxation could arise in relation to other taxes.[86] Given the nature of the issues at that time (including the perception of the "very limited" nature of double taxation arising as a consequence of such other taxes[87]) that decision may well have made eminent good sense then. But over the last ninety years or so things have, as the OECD has frequently reminded us during the BEPS project, moved on. The very significant amount of discussion of international tax reform ideas suggests it is now appropriate to think beyond running repairs to the system – and that would include the need for some consideration of how the issues highlighted in this paper might best be approached so that the functioning of the international tax system may be advanced, not merely maintained or left stagnant.

4. Conclusions

It is clear from the discussion that, by reason of the entirely different bases of the DBCFT and traditional taxes on corporate income, double tax treaties are not (and were of course never designed to) be a suitable mechanism for dealing with the interaction between the tax systems operated by what is here referred to as a DBCFT state and a non-DBCFT state. There are various ways in which tax treaties are a poor "fit" in this situation, raising issues for both states.

The difficulties are arguably especially marked if the DBCFT is regarded as a tax on "income", with the result that it is regarded as a "covered tax" for treaty purposes. It is hard to reach a definitive conclusion on whether the DBCFT amounts to a tax on income, mainly due to the vagueness of the concept of income, though the earlier discussion provides some indications that it may not be. There are significant design choices relating to the form in which any DBCFT might be enacted. These choices are likely to influence, if not largely determine,

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[85] The discussion here would suggest that the existing treaty system also represents a barrier to innovation. As to whether the DBCFT is an improvement on the existing international tax system, Dhammika Dharmapala identifies ten types of inefficiency created by the current corporate income tax regime, by reference to which he evaluates alternative reform proposals. The conclusion in respect of a proposal such as the DBCFT is that it would solve virtually all of the inefficiencies associated with the corporate income tax. See Dhammika Dharmapala, The economics of corporate and business tax reform, Oxford University Centre for Business Taxation, Working Paper 16/04, p. 3.

[86] See League of Nations, Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations, Geneva, 7 February 1925 (Document F.212) Note to Part III of the Report at p.28. However, there was some discussion subsequently whether the efforts on double taxation should be extended to other taxes – see further Patricia Brandstetter, Taxes Covered, A Study of Article 2 of the OECD Model Tax Convention, IBFD Amsterdam 2011 at pp. 92-94.

[87] See League of Nations, Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations, Geneva, 7 February 1925 (Document F.212) Note to Part III of the Report at p.28.

the issue as to whether the DBCFT falls within the scope of treaties, specifically as determined by Article 2 of the OECD Model.

As a practical matter, it seems likely that a state introducing a DBCFT would probably aim to keep the DBCFT largely outside the scope of existing treaties if possible. In any event, there are in this situation various policy issues for both DBCFT states and non-DBCFT states that would influence their approach and may lead to some re-negotiation of elements of the treaty concerned. It is therefore to be expected that the status of the DBCFT for treaty purposes will be settled by negotiation and agreement between the relevant states. In the specific case of the US-UK double tax treaty, there is a ready mechanism that would specifically cater for this approach, namely the MAP process. It seems inevitable that political as well as technical factors would influence the outcome of any such negotiations. The issues discussed here also raise wider questions on the ability and suitability of the existing international tax system to accommodate change intended to improve that system.

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