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Developing World Wary Of Sales-Based Tax Trend

By **Alex M. Parker**

Law360 (November 8, 2019, 9:15 PM EST) -- Around the world, sales- and destination-based taxing methods are gaining prominence as countries aim to nail down hard-to-catch corporate dollars, but nongovernmental organizations and advocacy groups claim this trend could leave poorer countries no better off.

A global effort among world leaders to revamp the international tax rules at the Organization for Economic Cooperation and Development has sparked a debate over how to best help developing countries desperate to bring in more revenue with cash-strapped and often understaffed tax administrations. While advocacy groups want to create more systems in which taxable income is tied to a company's workers, OECD officials — and some economists — claim this method would actually backfire.

The debate demonstrates how the OECD's project — once solely focused on how to tax online companies — has grown into a reevaluation of all of the rules and norms governing the international tax system.

The organization last month unveiled the latest version of its signature proposal, which would create a new international framework to apportion the taxable income of multinational corporations, giving market jurisdictions a bigger slice of the pie. According to proponents of this concept, including U.S. officials, this would capture income from e-retailers, social networks and other online platforms that don't need to use physical facilities and staff to enter a market, while not targeting technology companies directly.

To many critics of the international tax system, it also indicated a small but clear shift away from the principles that have underpinned the international tax system for nearly a century. This new apportionment system, which the OECD intends to be used alongside the current framework, would not be based on the arm's-length standard — the global benchmark for income allocation stating that tax authorities use market prices of assets to determine taxable income in their jurisdictions. The OECD's plan bore a much closer resemblance to a formulary system, which looks at the global profit of a corporation and divides it based on factors such as sales, payroll or employment.

Deciding which factor to use, however, has always been the biggest hurdle in the formulary approach. Advocates of a sales-based system claim it's a simple, easy-to-track method that would allow for the least amount of gaming or complex tax planning. But opponents say it would tilt the playing field towards wealthier countries with the most consumers, while short-changing the poorer countries where many of the products are actually made.

"An equitable distribution of taxing rights can only be achieved through a balanced formula that includes supply and demand factors, as allocation based on sales tend to advantage advanced economies who consume more whilst developing countries significantly benefit if employment is included in any allocation formula," the Independent Commission for the Reform of International Corporate Taxation wrote in a report last month.

Pascal Saint-Amans, the OECD's deputy director for tax policy, strongly pushed back against this view. During a joint conference sponsored by the International Monetary Fund and the World Bank in October, **he claimed** an employment-based system could reduce tax revenue for developing countries by encouraging jurisdictions to compete for investment by lowering their rates. Companies could reduce their tax bill by moving factories or facilities to the country with the lowest rates.

"If companies are so good to adapt to everything, why wouldn't they adapt to something which is mobile?" Saint-Amans asked.

It's a debate economics and tax law professors have engaged in for decades, with no clear resolution. But many believe a destination-based system would be the best way to not only prevent tax avoidance through manipulation of income reporting rules but also to prevent tax competition.

"The problem that all countries have, including developing countries, is that they simultaneously want to attract investment from multinationals, but they also want to raise more tax revenues," said Michael Devereux, a professor of business taxation at the University of Oxford. "And those things tend to conflict."

Devereux said basing taxation on employment is likely better for poorer countries in static terms, but over years they can lose out due to the mobility of the factories and facilities that employ workers. A company can move almost every part of its supply chain, but it can't move where its consumers are.

"The people buying it in Botswana, you can't sell to them any other way," he said.

Indeed, as corporate income revenues have fallen worldwide, consumption-based taxes such as the value-added tax have become ubiquitous in the developing world. For resource-strapped and undermanned tax administrations, the relative simplicity of the VAT makes it an attractive option, despite drawbacks such as a regressive impact on taxpayers.

Some academic research using available data — including from U.S. states, which have used a formulary system in the past that includes a payroll factor — does show that employment-based factors can cause more elasticity than factors such as sales.

"Tax competition will not disappear under formula apportionment and might intensify if the factors in the formula are mobile across borders," an IMF working paper published in October stated.

But others question whether the increase in tax competition would outweigh the benefit to workforce-heavy countries.

"In general it is not that easy to move employees around the globe," wrote Paul de Haan, a former international tax partner with PwC, in an email to Law360. "If the tax is not unfair and predictable, and available for double tax relief, companies are not likely to try and avoid paying it by complex restructuring. Tax is big but not that big." De Haan is now an independent tax adviser with CapaBuild, a nonprofit organization that provides tax training in developing countries.

Johan Langerock, a tax policy expert with Oxfam International, a nonprofit advocacy group that has pushed for formulary apportionment, said that tax competition already happens under the current system — but by including a balanced formula, the international tax system could put poorer countries on a more level playing field.

"If you only take sales into account, you come to an unfair distribution of profits," Langerock said. "You need to take more factors into account, you come to a more fair distribution of profits."

The OECD is also considering a global minimum tax that, in theory, could set a floor to tax competition around the world. But details, such as whether it will exempt certain industries or policies such as patent boxes for profits from intellectual property, could drastically change that result.

Despite the pressure, the OECD and Western nations involved in the project have given no indication that they will consider an employment formula as part of the project. To do so would bring the initiative even further from its original goal of taxing the digital economy, and suggest to many that it is a global renegotiation of basic taxing rights and principles.

But OECD officials have also said they will not finalize a plan unless all 135 members of the inclusive framework, a global tax coalition organized by the OECD, are on board. An impasse over this issue could not only doom the project but potentially threaten the OECD's status as the standard-setting body for global taxes, bolstering current movements to empower the United Nations or another body to take its place.

"We've called for a U.N. global tax body. But this is the forum we have now," Langerock said. "Our role is to politicize these debates, not to keep them as technical debates."

--Editing by Tim Ruel.