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TAXING DIGITAL BUSINESS: A PLEA FOR HOLISTIC THINKING

Digitalisation does not create new problems for the existing business tax system; it exacerbates existing problems. Problems that might have been tolerated for decades, now arguably threaten the system's nearer term viability. How? Essentially, by making it much easier for all aspects of a business to be spread across the globe. For example, in the pre-digital age goods could be sold cross-border with a minimal physical presence in the consumer's location. But in the digital age the scale of such transactions is many orders of magnitude greater.

This exacerbates three problems.

First, profit shifting: companies shift profits to low tax countries through well-known strategies which can be facilitated by digitalisation. For example, companies can transfer IP to low tax countries, and this planning strategy has been particularly effective with hard-to-value intangibles which are absolutely central to many digital businesses (it remains to be seen how effective the BEPS counter-measures will be).

Second, real economic distortions: companies move real activities such as R&D to low tax countries. This is again facilitated by digitalisation; in a world of modern communications, it is relatively easy for businesses to be run from many different locations, in increasingly complex supply chains.

The third follows from the first two. Because companies can shift profits and real activities, countries find themselves under competitive pressure to lower their corporate tax rates. This pressure explains why corporate tax rates have been declining for several decades – and why patent boxes have proliferated – but the pace of digitalisation is likely to exacerbate this decline.

The key underlying problem here is that the existing system seeks to tax businesses where mobile factors are located, including their place of residence, where production takes place and where IP is located. Digitalisation has increased mobility, and hence the problem.

But if this is the underlying problem, it is best addressed by moving towards a system which seeks to tax companies where more immobile factors are located. Consumers are considered to be broadly immobile – and therefore one option is to tax companies where their consumers are located – which in the jargon is known as the place of destination. Moving towards a destination basis for taxing business profit would have significant advantages on all three points mentioned above – though the advantages depend on exactly what destination base is chosen.

Such a move should not appear as controversial as it might have been even a few years ago. The current proposals for taxing the profits of the digital economy – including digital PEs – move us in this direction.

However, we should be clear that these measures constitute a significant departure from the existing system – which is based on residence and source. We have to be careful when overlaying ad hoc measures based on a destination principle onto the existing system, particularly if they are introduced without coordination. There is a real danger of increasing incoherence and complexity in the existing system by doing so.

A better option would be to move towards a destination basis in a coherent manner through comprehensive reform. This need not necessarily mean moving fully and exclusively to a destination basis of taxation, such as sales-based formulary apportionment or a destination-based cash flow tax, although the latter brings [clear advantages](#). We could move to a system which coherently allocates some taxing rights to the destination country but also leaves other countries with some rights to tax business profit. These systems can be viewed as an evolution of the existing system rather than a complete overhaul. For example, one possibility currently being studied by the CBT's [International Business Tax Group](#) is to allocate the right to tax routine returns to countries where economic activity takes place and the right to tax any residual profit to the destination country.

A move towards a destination basis would no doubt produce winners and losers among countries in the short term. However, decision makers should plan for the long and not the short term. They should keep in mind that the existing system will continue to be destabilised by competitive forces and tax rates will continue to be driven down, as mobility continues to increase. The US tax rate reduction to 21% is likely to spur another round of rate reductions. This is unsustainable in the long run. It implies that moving towards systems based on where immobile factors are located, such as destination, is ultimately not a matter of choice but of necessity. This might be the only viable option in the long run.

Recent relevant CBT research:

- **Michael P. Devereux and John Vella**, [Implications of Digitalization for International Corporation Tax Reform](#), *Oxford University Centre for Business Taxation Working Paper 17/07*, and in Sanjeev Gupta, Michael Keen, Alpa Shah and Genevieve Verdier eds. [Digital Revolutions in Public Finance](#), IMF.
- Alan Auerbach, Michael Devereux, Michael Keen and John Vella, “Destination-based cash flow taxation”, *Oxford University Centre for Business Taxation Working Paper 17/01*.
- Michael P. Devereux and John Vella, ‘[Are we heading towards a corporate tax system fit for the 21st century?](#)’ *Fiscal Studies*, 2014, vol 35.4, 449.