CORPORATE TAXATION IN THE GLOBAL ECONOMY

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Outline

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EXECUTIVE SUMMARY

The international corporate tax system is under unprecedented stress. The G-20/OECD project on Base Erosion and Profit Shifting (BEPS) has made significant progress in international tax cooperation, addressing some major weak points in the century-old architecture. But vulnerabilities remain. Limitations of the arm's-length principle—under which transactions between related parties are to be priced as if they were between independent entities—and reliance on notions of physical presence of the taxpayer to establish a legal basis to impose income tax have allowed apparently profitable firms to pay little tax. Tax competition remains largely unaddressed. And concerns with the allocation of taxing rights across countries continue. Recent unilateral measures, moreover, jeopardize such cooperation as has been achieved.

This paper reviews alternative directions for progress. The call for taxation "where value is created" has proved an inadequate basis for real progress. There now seems quite widespread agreement that fundamental change to current norms is needed—but no agreement, as yet, on its best form.

Key concerns are to better address both profit shifting and tax competition—and ensure full recognition of the interests of emerging and developing countries. Low income countries (LICs) are especially exposed to profit shifting and tax competition (and have limited alternatives for raising revenue) and their limited capacity is now stretched further by increased complexity. For them, securing the tax base on inward investment is key.

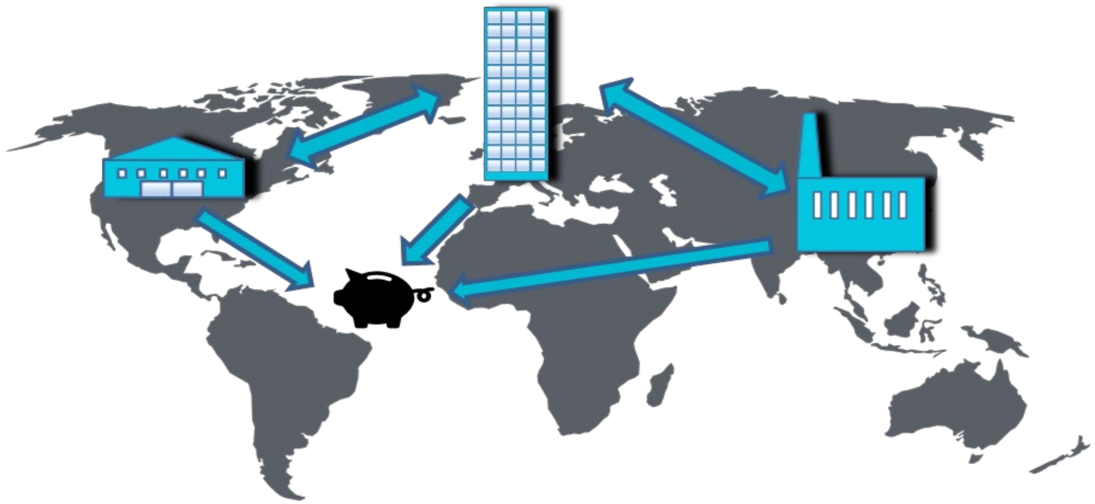
Alternative international tax architectures differ not only in their economic properties, but in how far they depart from current norms and the degree of cooperation they require. No scheme is without difficulty, but there are clear opportunities for improvement:[1]

- ***Minimum taxes on outbound investment*** can offer significant though incomplete protection against profit shifting and tax competition and generate positive spillovers for other jurisdictions (other than those with low tax regimes). ***Minimum taxes on inbound investment*** can be especially appealing for LICs. These schemes have the merit of being readily designed to complement current norms. But there is

- State of the international corporate tax system

- Alternative futures

The state of the international corporate tax system



Where things stand

Multilateral Progress:

- G20/OECD ‘Base Erosion and Profit Shifting’
- EU Anti-Tax Avoidance directive

But unilateral actions, some challenging norms:

- UK, Australia Diverted Profits taxes (2016)
- US tax reform, with novel international tax aspects
- Actions/proposals on ‘digital’ taxation

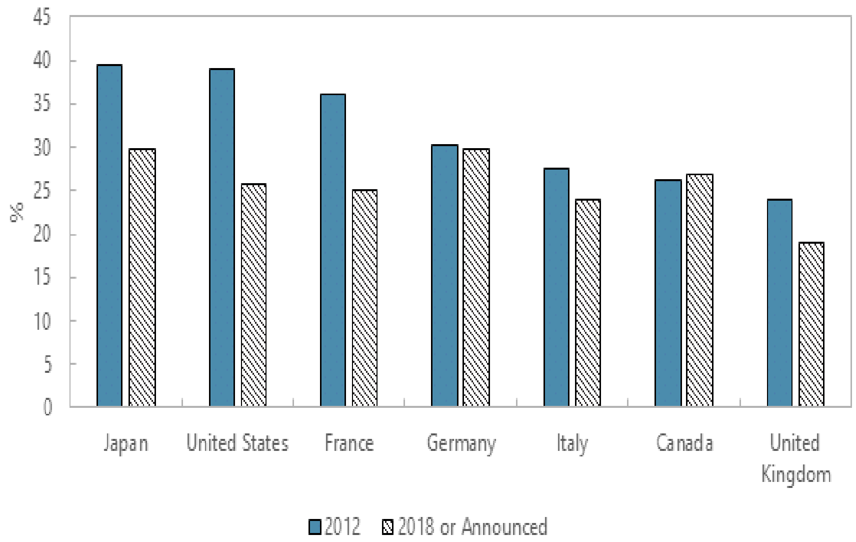
Issue 1: Continued profit shifting

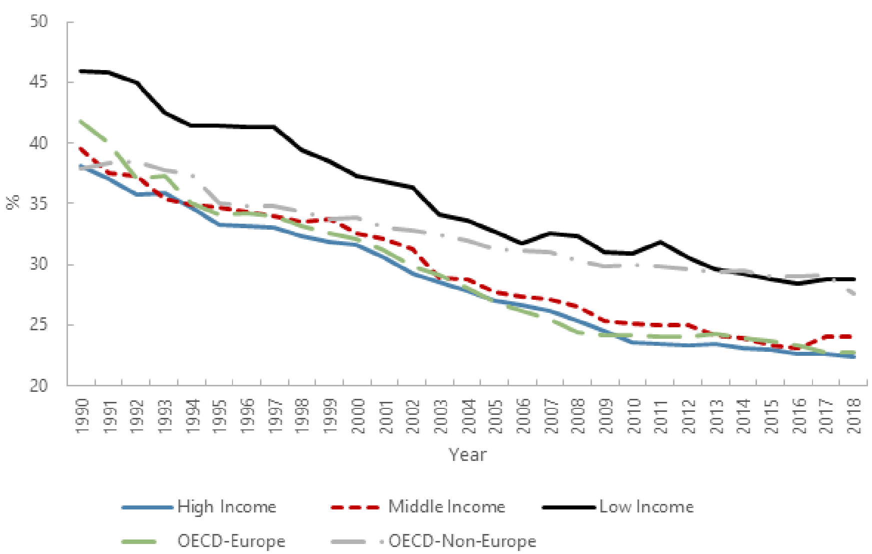
	Clausing (2016)	Beer, de Mooij, and Liu (2019)	Tørsløv, Wier, and Zucman (2018)
Year	2012	2015	2015
Canada	…	…	9
France	23	6	21
Germany	28	2	28
Italy	16	-6	19
Japan	18	3	6
U.K.	…	-12	18
U.S.A	26	15	14

- BEPS aimed at some of most egregious devices
- Limitations of arms length pricing

—E.g. does it make sense to conceive of risk being allocated <u>within</u> an MNE?

Issue 2: Tax competition

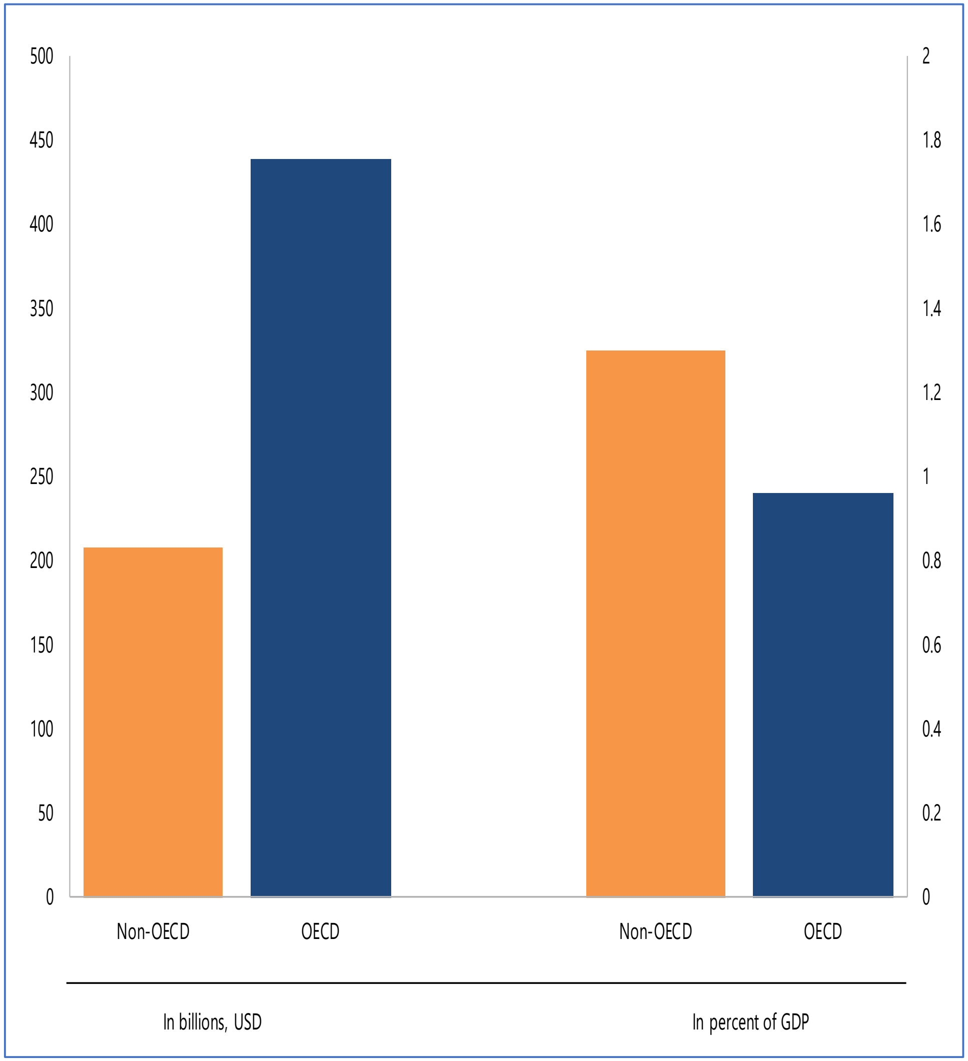




- Good or bad?
- Limiting avoidance may intensify competition for real capital
- Substance tests can lead to wasteful allocation
- Are preferential regimes necessarily harmful?

Issue 3: Developing Country Problems

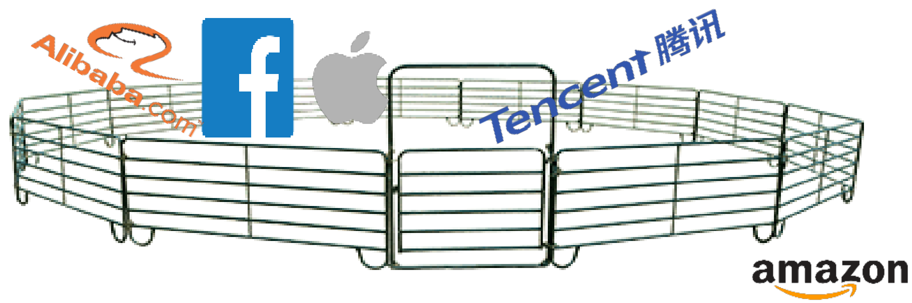
- More vulnerable
- Key areas:
  - —Treaties
  - —Interest
  - —Transfer pricing
  - —Offshore indirect transfers
- Capacity constraints
- Long-standing concerns in allocation of taxing rights



Issue 4: The Digitalization debate

What's New?

- Business without physical presence--?
- 'User-generated value'—but how distinguish from destination?

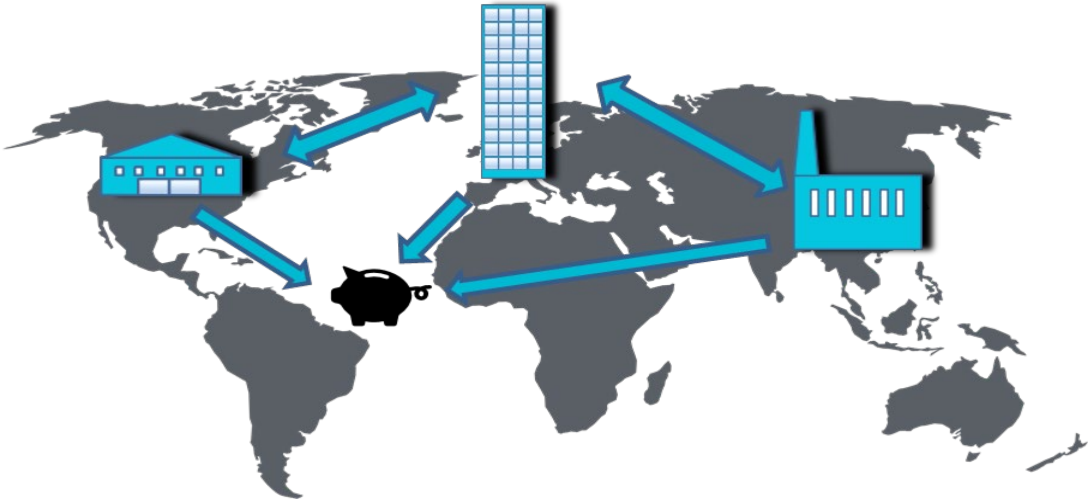


Proposals for:

- 'Digital Services Taxes'
- Longer term; virtual permanent establishment/share 'residual profit'

Emblematic of limits of "taxing where value is created" as a guide to policy

Alternative Architectures



Criteria

No established principles of international taxation

—Except a strong case for taxing rents somewhere

So, pragmatically, look at:

- Vulnerability to profit shifting
- And to [damaging] tax competition
- Ease of administration and compliance
- Legal obstacles
- Suitability for LICs

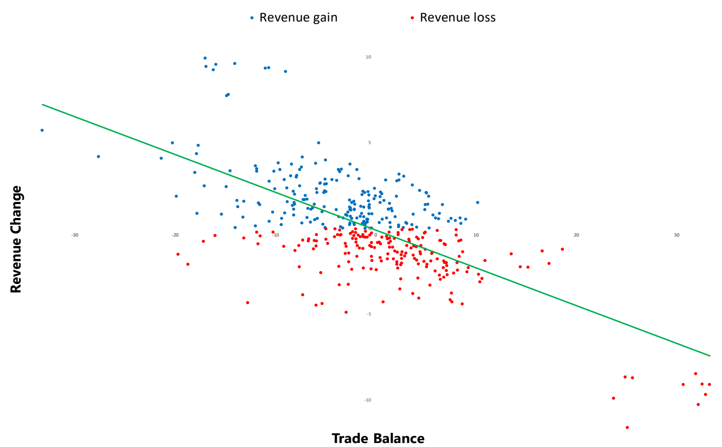
Impact may differ for common and unilateral adoption

Minimum Taxation

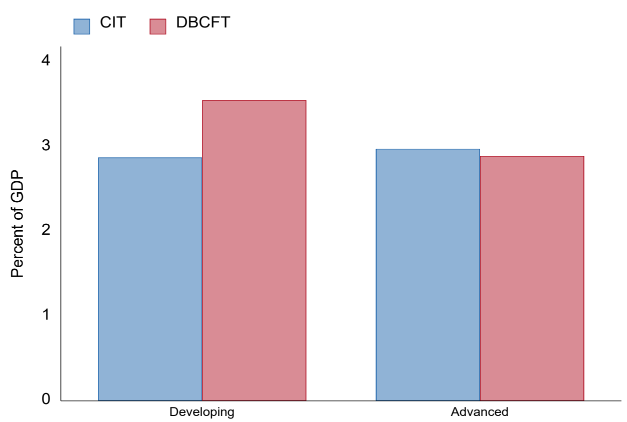
- Two aspects (inspired by TCJA)
  - —Outbound: Residence country taxes foreign earnings if tax abroad below some minimum
  - —Inbound: A minimum tax on resident affiliates' to combat base-eroding payments
- Attractions
  - —Reduces profit shifting and mitigates tax competition
  - —Close to current arrangements; modest need for coordination
  - —Developing countries gain from minimum on inbound
- Challenges/issues
  - —Can be blunt and increase distortions
  - —At what rate should minimum be set?

Destination-based Cash Flow Tax

Those with trade deficit more likely to gain …



… as well as developing countries



Source: Klemm and others 2019

DBCFT means

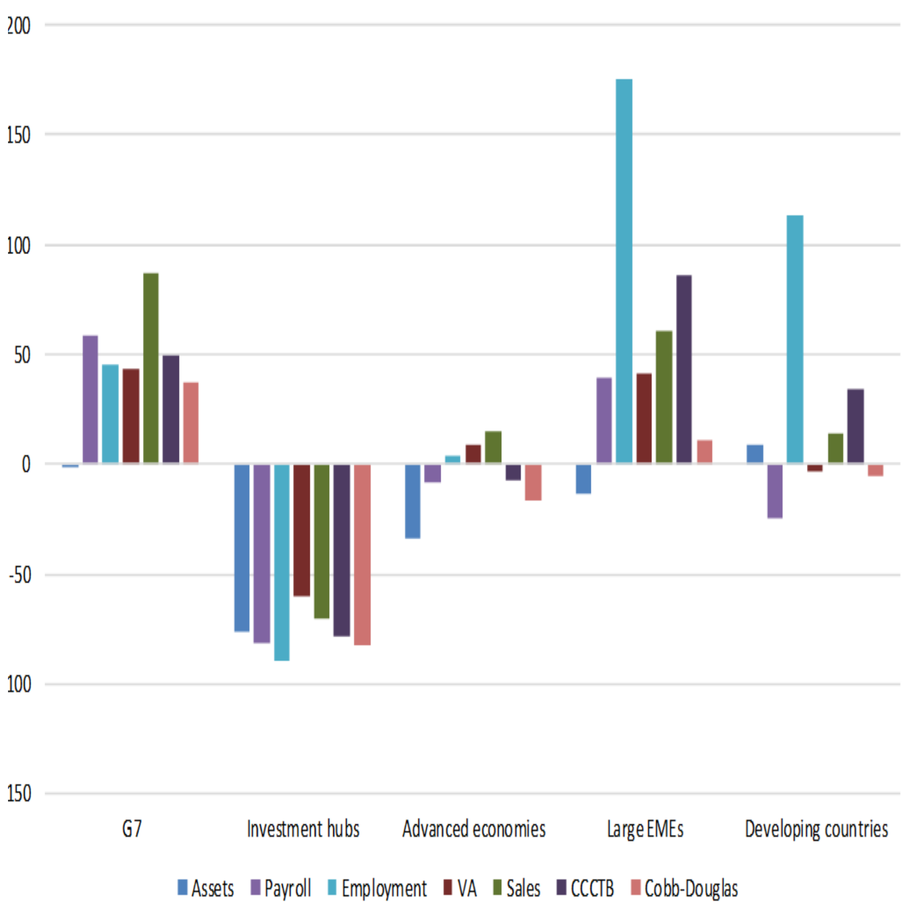
- —Expensing instead of depreciation
- —Exclude exports, include imports

- Advantages
  - —Robust to profit shifting and tax competition
  - —Falls on rents

- Challenges
  - —Remote from current norms (WTO)
  - —Dealing with refunds

Formula Apportionment

Analysis of U.S. MNC affiliates
Change in CIT revenue (in %) if unitary profit of U.S. MNCs is apportioned based on different formulas



Source: IMF (2019)

Advantages

—Eliminates profit shifting

But:

- It all depends on the base

  —Developing countries do not necessarily gain

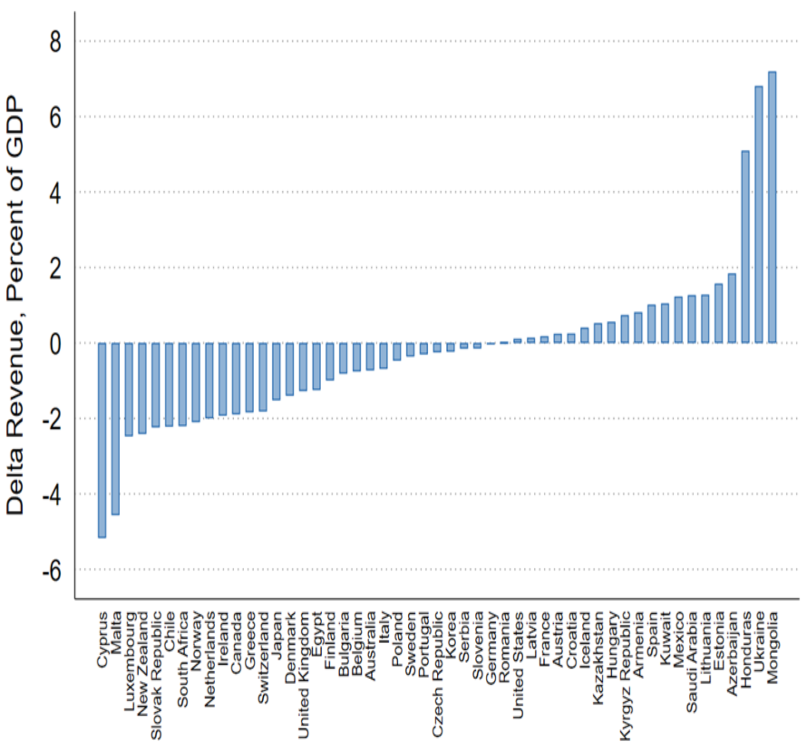
  —Risk of tax competition/game playing

- Much coordination needed

Residual Profit Allocation

Macro analysis

Revenue effect if CIT base is routine profit, measured as 10 percent of fixed assets in the corporate sector



Note: Δ Revenue= Revenue from routine profits minus CIT revenue.
Numbers are for 2017 or latest available year if 2017 is unavailable.

Source: IMF (2019)

RPA is a hybrid

- —Allocate 'routine' profit by ALP
- —Allocate residual by FA

Relative to FA:

- Assures at least routine return to source
- Less remote from current norms
- Fewer simplicity gains

Empirically, residual is

- Largely concentrated in US-HQ firms

Summary, with global adoption

	Protection against:		Ease of implementation:		Suitability to circumstances LICs
	Profit Shifting	Tax Competition	Practically	Legally	
Current arrangements					
Digital PE/significant economic presence					
Minimum taxation /2					/3
DBCFT					
FA /5					/4
RPA /6					

Low	Medium Low	Medium	Medium High	High

<u>Notes</u>:

/1 Source taxation is assumed to continue in the extractive industries.

/2 Minimum tax on both outgoing and inbound investment.

/3 Benefit mainly from inbound minimum.

/4 Gain most sure if apportionment largely by employment.

/5 Assumes apportionment partly by sales, all countries using the same formula; normal return assumed to be taxed.

/6 Robustness greater the more is apportionment by destination-based sales.