Is a sustainable tax on international profit feasible?

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Key Themes

- Existing system of taxing international corporate profit creates distortions to location of activity and structure of business
- Ability to tax international corporate profit undermined by
    - Opportunities for taxpayers to exploit existing system
    - Competition between governments
- Piecemeal attempts to modify system unlikely to be successful
- Any sustainable tax system must be incentive compatible

Outline of presentation

1: Some problems of the existing international corporate tax system

- Residence v source
- Active income v passive income
- Treating affiliates as independent

2: Competition between governments

3: The OECD BEPS Action Plan

4: A possible basis for relatively incentive-compatible structures

1. Problems of the international corporate tax system

OECD Model tax convention

- Main source of bilateral tax treaties; over 3,000 in total
- Based on “1920s compromise” of allocation of rights to tax international business income:

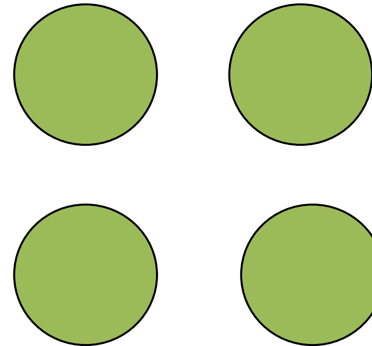
- **Active** business profits are taxed in the **source** country (Article 7)

- **Passive** income is taxed in the **residence** country
    - Dividends (Article 10)
    - Interest (Article 11)
    - Royalties (Article 12)

A. Source v Residence

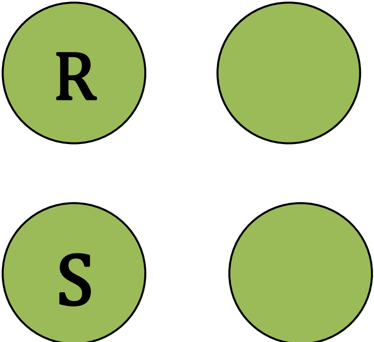
RESIDENCE	**SOURCE**
Investors	Economic activity
Parent company	Sales

A modern multinational company

PERSONAL RESIDENCE	PARENT COMPANY	AFFILIATES	SALES
			

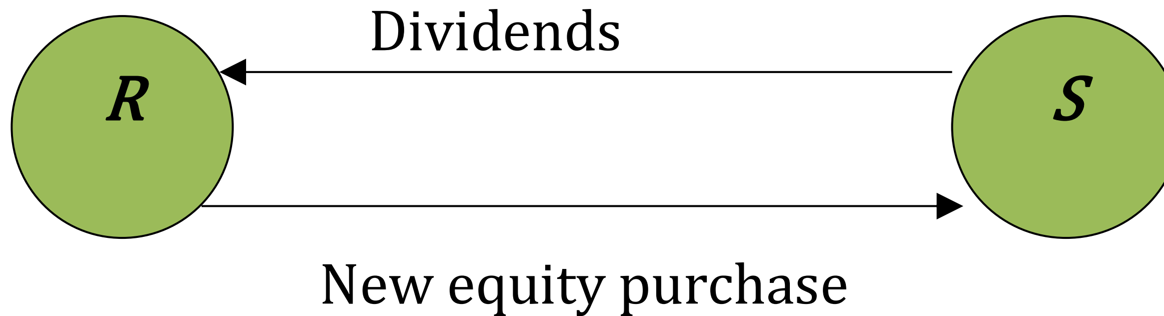
Source v Residence in a modern MNC

PERSONAL RESIDENCE	PARENT COMPANY	AFFILIATES	SALES



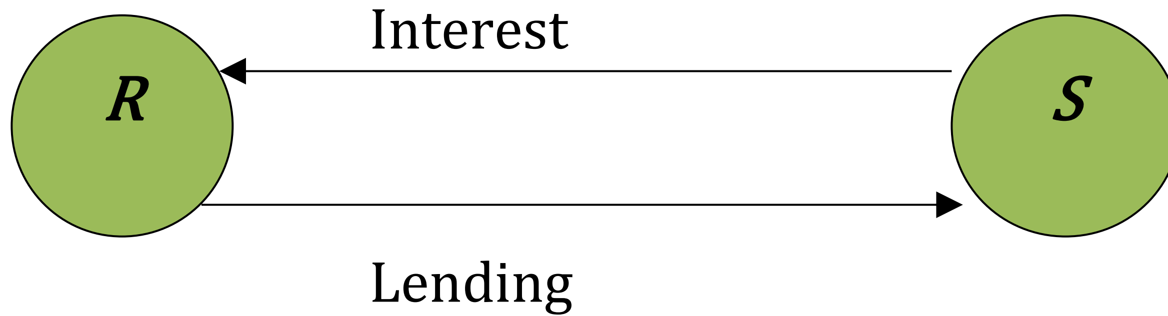
B. Active income v Passive income

I. Finance foreign investment by new equity



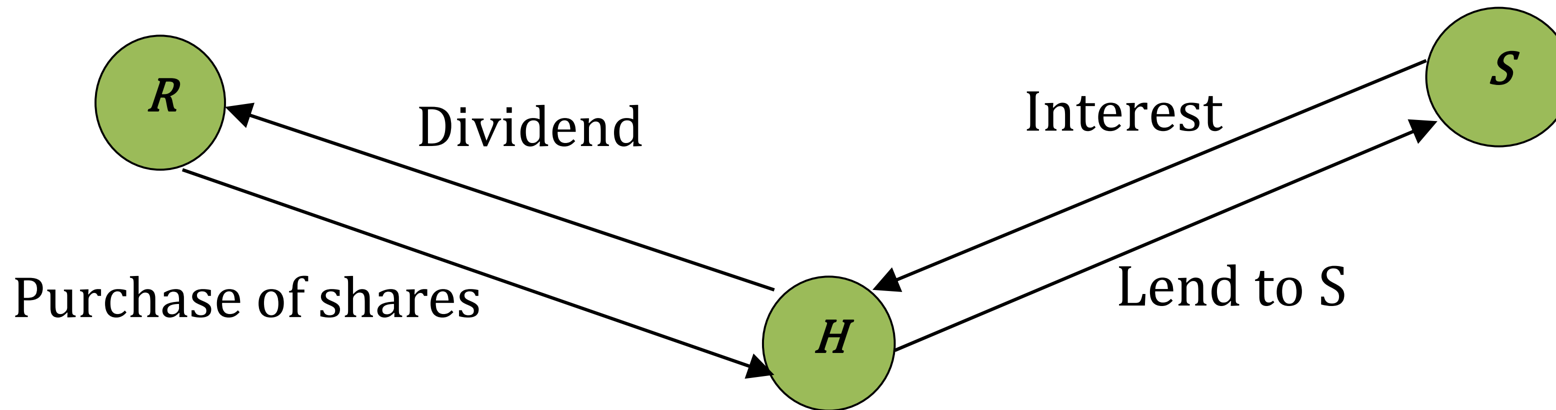
Active income taxed in S

II. Finance foreign investment by debt



Passive income taxed in R

III. Tax Planning 101

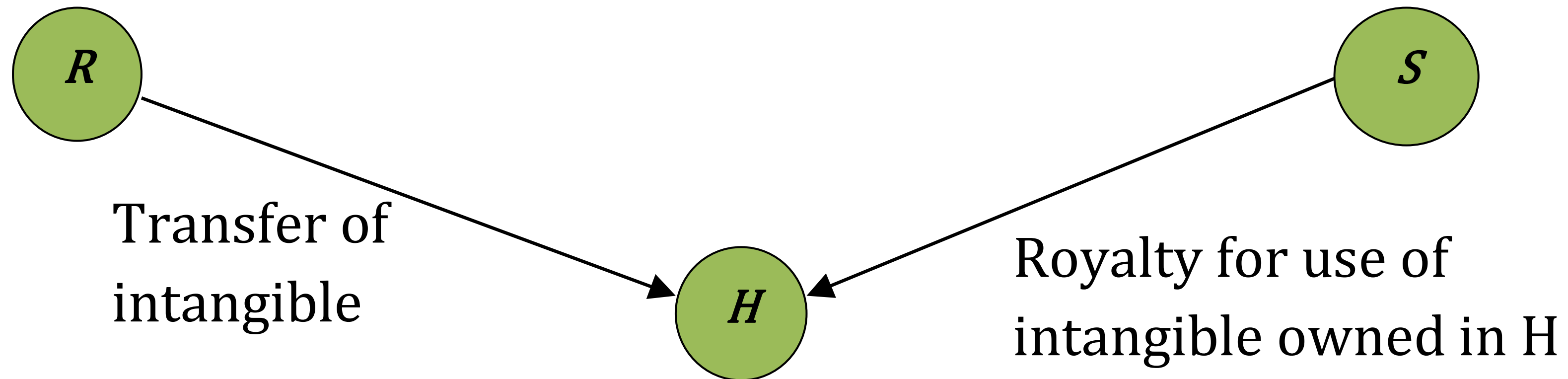


H is a tax haven subsidiary

No tax in S, H or R

Might also be achieved by hybrid instruments

IV. Royalties



Company in R undertakes research and development and develops intangible

No tax in S, H or R

C. Treating affiliated entities as independent

- Transfers within multinational must be priced for allocation of both active and passive income

- "Arm's length price" is price which two independent firms would use

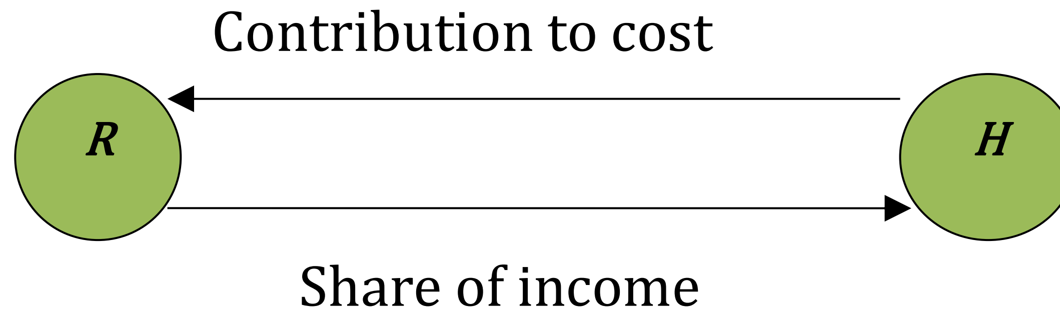
  - Has conceptual and practical difficulties
  - But existing system does need some means of pricing transfers

- Principle of equivalence with independent parties can go too far

  - For example: cost sharing agreements, and treatment of risk

I. Cost sharing arrangements

- **In previous example, how was asset transferred to H without tax?**



- R equity finances subsidiary in H
- H pays a share of R&D cost arising in R
- R agrees that H should receive the same proportion of royalty income arising

Reasonable if R and H are independent, but not if R owns H

II. Risk

- H is a wholly-owned subsidiary of R; no 3rd party creditors
- H and R have contract for some transaction, in which H bears the risk
- H allocated higher share of joint profit to compensate for taking on risk

Reasonable if R and H are independent, but not if R owns H

Risk is borne by the shareholders of R; risk cannot be transferred to H

2. Competition between governments

What do governments aim to achieve?

- Attract real economic activity?
- Attract taxable profit?
- Benefit domestic companies by generating competitive advantage?

An example: Recent competition by the UK

1. Reduction in tax rate from 28% to 20% - and soon to 18%

2. Introduction of patent box to tax royalty income at rate of 10%

3. Generous R&D tax credits

4. Generous treatment of interest deductibility

"The UK's current interest rules, which do not significantly restrict relief for interest, are considered by businesses as a competitive advantage; other comparable countries tend to have more severe restrictions on such relief."

5. Generous Controlled Foreign Company (CFC) rules

6. Introduction of Diverted Profits Tax

Examples of competition to favour home companies

1. UK Finance Company rules

   - UK companies that divert interest income to tax havens face tax rate of only 5% on that income

2. US "Check the box" rules

   - US companies that divert interest and royalty income to tax havens escape tax entirely
     - Until repatriated to the USA

3. The OECD BEPS Action Plan

From global perspective, what should the aims of the international system be?

- Collect revenue , while
- Avoiding distortion to location of economic activity
- Avoiding creation of competitive advantage for one business over another

OECD BEPS (Base Erosion and Profit Shifting) project focused only on revenue:

- System created to avoid double taxation; perceived problem now is "double non-taxation"

Complex multi-dimensional game between OECD members and some non-members

- NOT an exercise in identifying the global optimal tax system

Key principle of BEPS

- is to require “economic activity”, “relevant substance” or “value creation” in place of taxation, eg.

“This Action Plan should provide countries with domestic and international instruments that will better align rights to tax with economic activity”
OECD Action Plan on BEPS, page 11

Is that a good principle? 5 problems

1. “Economic activity”, “relevant substance” or “value creation” are not defined
   - Provision of funds by individual shareholders? Management? Research and development? Production? Marketing? Sales?

2. Inconsistent with the original “residence” principle for passive income, yet expected to operate alongside it

3. Could lead to double taxation
   - What if transfer of intangible from R to H is taxed at full rate in R?
   - No need for further taxation in H or S

4. In at least some cases, it is a misdiagnosis of the problem
    - Source of problem of intangibles is lack of tax on transfer of asset to haven

5. It may create real economic distortions
    - Minimal level of economic activity will move to H, creating real economic distortion, where there was none

Can BEPS solve the tax competition problem?

OECD would like tax to be in Residence or Source country, not in Haven

- But governments in R and S could both levy tax **now**, eg.
  - R could tax the receipt of interest or royalty in H
  - S could prevent deduction for interest or royalty

- Typically R and S choose not to
  - R may believe it is giving a competitive advantage to its companies
  - S may believe it is making itself more attractive for inward investment

So OECD ignores fundamental problem of incentive compatibility

Where will we be post-BEPS?

- A confused, complex mass of arcane, arbitrary and sometimes illogical rules – not a corporation tax fit for the 21st century

  - Cross-country arbitrage opportunities will remain

  - Competition will still drive rates down and reliefs up

  - Location of real economic activity will still be distorted

  - Competition between businesses will still be distorted

4. Incentive Compatibility

- Reduce incentive to undermine tax capacity elsewhere
  - Question for any proposed tax system: would a small open economy have an incentive to compete in any dimension?

- In principle: levy tax on profit in location of less mobile activities or income
  - Points to taxation based on residence of, or consumption by, individuals
  - For example: no competition in VAT rates

Destination-based cash flow tax

- Abolish interest deductibility, allow immediate expensing
  - Like VAT, except that labour costs deductible

- Tax imports and zero-rate exports
  - Like VAT

In theory, if implemented in all countries (and individuals were immobile):

- Would not affect location, investment or finance
- transfer prices become irrelevant
- countries would not need to compete over tax rates
- Tax would fall on spending out of non-labour income in domestic
  - So equivalent to a tax on domestic shareholders

Incentive compatible?

Suppose other countries had a source-based cash flow tax

Then, theoretically, a trade-off:

- Destination-based cash flow tax would remove tax in location of "production"
  - Would attract investment

- Source-based cash flow tax would fall on owners of company
  - With cross-border shareholding, SB tax partly borne by foreigners

First point holds in comparison with existing tax

Second point may not

Practical difficulties?

Asymmetry in tax

- Expenditure relieved in country in which it is incurred
- Sales taxed in country in which they are made

- So an exporting firm could face a negative tax base in country of production

Difficult to tax in place of consumption? especially digital services

- For co-operating countries, envisage a one-stop shop approach, as for VAT from 2015

Concluding Thoughts

Problem of non-taxation of multinational profit due to

1. Fundamental problems in set-up of international tax system, including

    a. Basic allocation of taxing rights between source and residence, and active income and passive income
    b. Rules for allocating profit between countries

2. Competitive pressures between governments to attract real activity and profit

Any sustainable solution will have to address both issues